The Tax and Practical Aspects of the Installment Sale to a Spousal Grantor Trust

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The familiar installment sale to a grantor trust, where a taxpayer sells property to his or her wholly-owned grantor trust, is an effective technique to shift assets among family members on an income and estate tax efficient basis. A variation on this traditional technique is a sale by a trust beneficiary to a grantor trust treated as wholly-owned by the beneficiary's spouse (the "spousal grantor trust sale").[1] Similar to the traditional grantor trust sale, the spousal grantor trust sale accomplishes a freeze on the value of the consideration received on the sale for estate tax purposes. However, the spousal grantor trust sale provides several meaningful advantages over the traditional grantor trust sale, including the potential ability of the selling spouse to be a beneficiary of the trust, possess a special testamentary power of appointment over trust prop-

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[1] *See, e.g.*, Andrew F. Dana, *Till Death Do Us Part: The Riddle of Note Basis in a Sale to a Spouse's Grantor Trust*, 114 J. Tax'n 340 (2011); S. Stacy Eastland, *The Art of Donating Your Cake to Your Family and Eating it Too: Current Gift Planning Opportunities Using Strings that are Not Considered Attached by the Donor*, 47 U. Miami Heckerling Inst. on Est. Plan. 64 at 66 (2013); Diana S.C. Zeydel, Cutting Edge Estate Planning Ideas: What Have I Learned from My Colleagues? ¶ I(B).

erty, or serve as trustee of the spousal grantor trust. This article analyzes the tax and practical aspects of an installment sale to a spousal grantor trust, and how it differs from a traditional grantor trust sale.

I. Introduction

The spousal grantor trust sale provides unique opportunities that may not be available with a traditional grantor trust sale or other freeze techniques. In a traditional grantor trust sale, a taxpayer establishes an irrevocable trust for the benefit of the taxpayer's spouse and/or descendants, makes a seed gift to the trust, and subsequently sells what the taxpayer hopes to be appreciating property to the trust in exchange for a down payment and an installment promissory note. Because the irrevocable trust is treated as wholly-owned by the taxpayer for income tax purposes, no gain is recognized on the sale, no gain is recognized upon receipt of installment payments on the promissory note, and interest payments on the promissory note are not subject to income tax. Importantly, in order to avoid estate tax inclusion, the taxpayer cannot retain a beneficial interest in or power of appointment over the grantor trust and cannot serve as trustee of the grantor trust. This can be a significant impediment for some clients who are concerned about current estate planning that may be beyond their potential future means, or the loss of access to or control over important business, family or other valued assets. In addition, special complications may exist when planning for closely-held business owners, where ownership or control of the business may be limited by shareholders agreements, distributor or franchise agreements, or lending or bonding requirements, and negotiation or review of any changes may require the approval or consent of third parties.

A unique alternative to the traditional grantor trust sale involves a sale of property by one spouse (the "selling spouse") to an irrevocable trust that is treated as wholly-owned by the other spouse (the "grantor spouse") for income tax purposes.[2] Because the spousal grantor trust is treated as wholly-owned by the grantor spouse for income tax purposes,[3] a sale of property by the selling spouse to the trust should be treated as a transfer of property between spouses, and thus receive non-

[2] An irrevocable trust established by the grantor spouse, to which the selling spouse sells property in exchange for an installment note, is referred to throughout this article as a "spousal grantor trust."

[3] *See* Rev. Rul. 85-13, 1985-1 C.B. 184 (holding that a grantor treated as the owner of an entire trust under the grantor trust rules is considered the owner of the trust assets for federal income tax purposes).

recognition treatment by virtue of Section 1041.[4] Among the reasons why a taxpayer may prefer a spousal grantor trust sale to a traditional grantor trust sale are the following:

1. The selling spouse could be a beneficiary of the spousal grantor trust;
2. The selling spouse could have a testamentary special power of appointment over the assets of the spousal grantor trust; and
3. The selling spouse could serve as a trustee of the spousal grantor trust.

Of course, the above-listed considerations that may increase the perceived attractiveness of a spousal grantor trust sale are dependent on structural and valuation issues, discussed in more detail below. Nonetheless, there is at least a possibility that the selling spouse could possess some interest in or control over the trust property and yet avoid estate inclusion, aspects that are *per se* prohibited with the traditional grantor trust sale.[5]

For married clients who are reluctant to engage in a traditional grantor trust sale because of the loss of the economic benefit from, or control over, assets sold to the grantor trust, the spousal grantor trust sale offers a unique option to engage in sophisticated estate tax reduction planning without the perceived lifetime disadvantages of a traditional grantor trust sale. A sale of property to a spousal grantor trust in exchange for a cash down payment and promissory note, however, is not without its own unique set of tax issues, including the taxation of interest income on the installment promissory note, whether gain is recognized on the sale after the death of either spouse, and the risk of inclusion of the trust property in the selling spouse's gross estate.

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4 *See*, *e.g.*, Treas. Reg. § 1.1041-1T(a), Q&A 2, Ex. 2 (providing that sale of property in the ordinary course of business from spouse's sole proprietorship to other spouse is a transfer of property between spouses subject to the rules of I.R.C. § 1041).

5 Another similar transaction is where a beneficiary sells property to a trust taxed to the beneficiary as grantor under § 678. The IRS has announced that it ordinarily will not rule on tax issues where the trust beneficiary had a withdrawal power sufficient to treat the beneficiary as the deemed owner under § 678, the beneficiary sells property to the trust in exchange for a note, and the value of the assets contributed to the trust by its settlor is nominal compared to the value of the property purchased. Rev. Proc. 2019-3, 2019-1 I.R.B. 130 § 4.01(43), (49), (52), (60). Although it involves a beneficiary selling property to a trust, the circumstances of the spousal grantor trust sale are different since the selling spouse at no time possesses a power to withdraw the trust property.

II. Summary of Treatment for State and Federal Tax Law Purposes

Under state law and federal tax rules, a sale of assets from the non-grantor selling spouse to a spousal grantor trust should be treated as follows:

1. **State Law Treatment.** The sale should be treated as a sale of property for valuable consideration between the selling spouse and the spousal grantor trust that is binding on both parties to the transaction, and their successors.
2. **Gift Tax Treatment.** If the selling spouse sells property to the spousal grantor trust for full and adequate consideration in money or money's worth, the selling spouse should not be treated as making a taxable gift to the spousal grantor trust for gift tax purposes. The selling spouse could consider filing a gift tax return to adequately disclose the "non-gift" transaction and begin the running of the gift tax statute of limitations on the sale.[6] The selling spouse could also consider using a formula clause in the trust and/or sale documents to minimize the risk of an inadvertent taxable gift at the time of the sale.[7] The particular interests or powers granted to the selling spouse under the terms of the spousal grantor trust could render any potential gift by the selling spouse incomplete for gift tax purposes.
3. **Estate Tax Treatment.** To avoid inclusion in the selling spouse's gross estate under Sections 2036 or 2038, the sale must be bona fide and for full and adequate consideration in money or money's worth, as determined at the time of the selling spouse's death. The running of the statute of limitations on a gift tax return that adequately disclosed the transaction in the year of the sale likely would not apply to bar a challenge to the sale's bona fides or consideration for estate tax purposes.[8]
4. **Income Tax Treatment.** Generally, Section 1041 provides that no gain or loss is recognized on a transfer of property from an individual to his or her spouse. Section 1041 applies to any transfer of property between spouses, regardless of whether the transfer is a gift or a sale or exchange

[6] Treas. Reg. § 301.6501(c)-1(f)(4).

[7] *See infra* Part V.C.2.

[8] *See*, *e.g.*, Austin W. Bramwell, *Considerations and Consequences of Disclosing Non-Gift Transfers*, 116 J. Tax'n 19 (2012).

between spouses acting at arm's length.[9] The transferred property is treated as acquired by the transferee spouse by gift,[10] and neither the transferor nor the transferee spouse recognizes gain or loss on the transfer. The transferee spouse's basis in the property is the adjusted basis of the property in the hands of the transferor spouse immediately before the transfer.[11] The transferred basis rule applies even if the transfer is a bona fide sale between spouses.[12] Although Section 1041 applies to a transfer of property between spouses, it does not prevent the taxation of interest payments made between spouses.[13] As a result, the selling spouse should include any interest payments received on the note in gross income. The spousal grantor trust (and thus the grantor spouse) likewise may be able to deduct the interest paid as an investment interest expense,[14] subject to any AMT limitations. Because a bona fide sale of property between spouses is subject to the rules of Section 1041, the exchange of property between the selling spouse and the spousal grantor trust should be treated for income tax purposes as separate gifts of property between the spouses:

a. **Gift from Selling Spouse to Grantor Spouse.** The selling spouse should be treated as making a nontaxable gift (to the grantor spouse) of the property sold to the

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[9] Treas. Reg. § 1.1041-1T(a), Q&A 2. The temporary regulations also note that in certain situations, general tax principles, such as the step-transaction doctrine, may apply to recharacterize a transaction otherwise not within I.R.C. § 1041 as a sale between spouses, such as a sale from a spouse's wholly owned corporation to the other spouse. *See* Treas. Reg. § 1.1041-1T(a), Q&A 2, Ex. 3 (although a sale in the ordinary course of business from one spouse's wholly-owned corporation to the other spouse is not subject to I.R.C. § 1041, in appropriate circumstances general tax principles, such as the step-transaction doctrine, may apply to recharacterize the transaction).

[10] I.R.C. § 1041(b)(1).

[11] I.R.C. § 1041(b)(2).

[12] Treas. Reg. § 1.1041-1T(d), Q&A 11.

[13] *See*, *e.g.*, Yankwich v. Comm'r, T.C. Memo. 2002-37, 83 T.C.M. (CCH) 1208 (2002) (portion of installment payments made under separation agreement allocated to interest properly included in income); Cipriano v. Comm'r, T.C. Memo. 2001-157, 81 T.C.M. (CCH) 1049 (2001) (interest payments received in connection with division of marital property were properly includable in income); Gibbs v. Comm'r, T.C. Memo. 1997-196, 73 T.C.M. (CCH) 2669 (1997) (interest payments made in accordance with divorce decree not within the scope of § 1041's nonrecognition provisions).

[14] Seymour v. Comm'r, 109 T.C. 279, 286 (1997) (providing that taxpayer may deduct interest payments on indebtedness payable to former spouse if properly characterized as investment interest, passive activity interest, or qualified residence interest, and not personal interest under § 163(h)(1)).

spousal grantor trust, and the spousal grantor trust should receive the selling spouse's basis in the property.

b. **Gift from Grantor Spouse to Selling Spouse.** The grantor spouse should be treated as making a nontaxable gift (to the selling spouse) of the installment note and any down payment or other consideration. The selling spouse should receive the spousal grantor trust's basis in the note and other property given as consideration for the sale.

If the sale is an installment sale from one spouse to the other, the question arises as to the income tax treatment of the transaction if one spouse dies prior to the time that the note is paid in full and the terms of the transaction have been completed. In addition, under certain circumstances, if the sale is not for full and adequate consideration for federal tax or state law purposes, then the selling spouse may be treated as having made a gratuitous transfer of property to the spousal grantor trust resulting in estate tax inclusion under Sections 2036 or 2038, such as where the selling spouse has a beneficial interest in the spousal grantor trust or the selling spouse's creditors can reach a portion of the spousal grantor trust under state law.[15] As discussed below, the facts and circumstances become highly important to establish a bona fide sale for full and adequate consideration for federal income and transfer tax purposes, as well as state law purposes.

III. Sale to Grantor Trust v. Spousal Grantor Trust

Although the estate tax savings that can be achieved from a traditional grantor trust sale and a spousal grantor trust sale are similar, there are a number of practical differences that present unique opportunities and challenges for a spousal grantor trust sale.

A. Estate Tax Savings

The estate tax savings that can result from a successful sale of assets to a spousal grantor trust are similar to the estate tax savings experienced in a traditional grantor trust sale. The assets sold, including future appreciation after the date of the sale, avoid estate taxes upon the death of the selling spouse. In addition, the payment by the grantor spouse (from assets that would otherwise be subject to estate tax) of the income taxes on the grantor trust income results in additional estate tax

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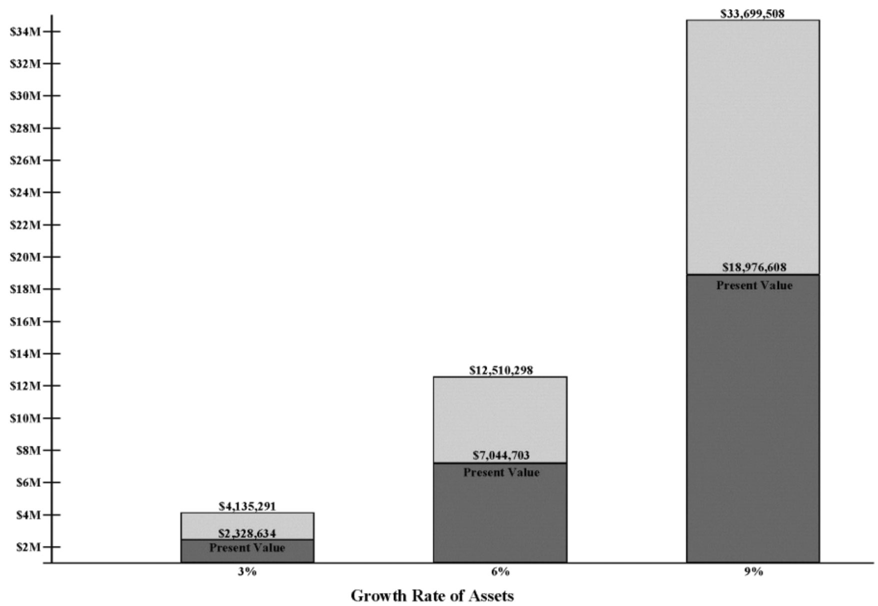
[15] *See generally* Phyllis C. Smith, *The Estate and Gift Tax Implications of Self-Settled Domestic Asset Protection Trusts: Can you Really Have Your Cake and Eat It Too?*, 44 New Eng. L. Rev. 25 (2009).

savings for so long as the grantor trust status of the trust is maintained. Consider the estate tax savings for a taxpayer who engages in a traditional grantor trust sale or spousal grantor trust sale and dies 30 years later, where a $700,000 seed gift is made to the trust, a $650,000 down payment is made to the selling spouse for the sale of assets having an undiscounted liquidation value of $10 million for $6.5 million, after applying a 35 percent valuation discount.[16]

ESTATE TAX SAVINGS
GRANTOR TRUST SALE VERSUS NO PLANNING



B. A "Blessed" Freeze Transaction for Income Tax Purposes?

On the surface, a spousal grantor trust sale raises income tax issues similar to a traditional grantor trust sale, including questions regarding the income tax basis in a promissory note received in the sale or whether the unrecognized gain inherent in the sale should be recognized upon the death of a spouse. The underlying premise for the traditional grantor trust sale begins (and ends) with Revenue Ruling 85-13,[17] which pro-

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16 For illustrative purposes, the example compares a hypothetical installment sale to no estate planning, and assumes (i) a 40 percent estate tax, (ii) utilization of transfer tax exemption to shield the seed gift from gift tax, (iii) no exemption remaining at death, and (iv) income taxes on trust income are paid out of the grantor spouse's personal estate.

17 Rev. Rul. 85-13, 1985-1 C.B. 184.

vides that transactions between a grantor and a wholly-owned grantor trust are completely ignored for income tax purposes.

The spousal grantor trust sale, however, is not a completely ignored transaction for income tax purposes because it falls within the purview of Section 1041 as a transfer of property between spouses for income tax purposes. As such, the Code mandates nonrecognition treatment and the acquisition of a transferred basis for property received in the sale. Has the Code therefore "blessed" the income tax implications of a spousal grantor trust sale?

C. Revenue Ruling 85-13: Grantor Spouse Treated as Owner of Assets Held by Wholly-Owned Spousal Grantor Trust

The income tax analysis of the spousal grantor trust sale differs from a traditional grantor trust sale because the transaction is not wholly-ignored for income tax purposes. It is true that the income tax analysis begins with Revenue Ruling 85-13 and its conclusion that a grantor that is treated as the owner of an entire trust is considered to be the owner of the trust's assets for federal income tax purposes. Pursuant to this proposition, it follows that assets held by a spousal grantor trust are treated as held directly by the grantor spouse for income tax purposes.

The remainder of the income tax analysis, however, extends beyond Revenue Ruling 85-13, and is brought squarely within the Code's income tax provisions. These provisions expressly contemplate a sale of property between spouses—including a sale between one spouse and an entity disregarded as separate from the other spouse for income tax purposes—and require that the transaction be a non-recognition event treated as a gift for income tax purposes.[18] The spousal grantor trust sale is not an ignored transaction, but rather is governed by Sections 1041 and 102, instead of Sections 1001 and 1012. As a result, Section 1041's characterization of a sale between spouses as a transfer of property by gift and its transferred basis provisions form the foundation for the income tax analysis of a spousal grantor trust sale.

D. Section 1041: Income Tax Treatment of Property Transfers between Spouses

Section 1041 generally provides that no gain or loss is recognized on a transfer of property to, or in trust for the benefit of, a spouse.[19] Fur-

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[18] *See*, *e.g.*, Treas. Reg. § 1.1041-1T(a), Q&A 2, Ex. 2 (providing that a sale of property in the ordinary course of business from spouse's sole proprietorship to other spouse is a transfer of property between spouses subject to the rules of I.R.C. § 1041).

[19] I.R.C. § 1041(a).

ther, any transfer of property from an individual to (or in trust for the benefit of) a spouse is treated as acquired by the transferee spouse by gift, and the transferee spouse takes the transferor spouse's basis in the property.[20] An exception to this general non-recognition rule applies where an individual transfers property with liabilities in excess of basis to a trust for the benefit of his or her spouse, in which case the transferor spouse recognizes gain to the extent that liabilities exceed basis, and the transferee spouse receives a basis adjustment to account for the gain recognized by the transferor spouse.[21] If, however, the transfer of property with liabilities in excess of basis is between the spouses and not in trust, the transferor spouse does not recognize any gain, and the transferee spouse takes the transferor's basis in the property.[22]

The temporary regulations clarify that even if the transfer between spouses is a bona fide sale, the transaction nevertheless is governed by Section 1041, and "the transferee does not acquire a basis in the transferred property equal to the transferee's cost (the fair market value)."[23] This pronouncement is similar to Revenue Ruling 85-13, which held that a grantor acquires a transferred basis in property purchased from a wholly-owned grantor trust, rather than a cost basis. On those facts, a grantor purchased property from a wholly-owned grantor trust, and for which the trust had a basis of $20, in exchange for a $40 unsecured promissory note bearing adequate interest payable semiannually, and principal payable in ten equal installments beginning three years after the date of purchase. Roughly three years later, the grantor sold the property to a third party for $50. The IRS ruled that the grantor did not receive a cost basis in the property ($40—the face amount of the installment note), but rather took the trust's basis ($20) because the purchase of the property from the grantor trust was disregarded for income tax purposes. In effect, the ruling provides that basis follows the transferred property in transactions that are disregarded for income tax purposes.[24]

In the spousal grantor trust sale scenario, the temporary regulations suggest a similar result, so that a wholly-owned spousal grantor trust should take the selling spouse's basis in property sold to the trust, rather

20 I.R.C. § 1041(b).

21 I.R.C. § 1041(e).

22 Treas. Reg. § 1.1041-1T(d), Q&A 12.

23 Treas. Reg. § 1.1041-1T(d), Q&A 11.

24 Rev. Rul. 85-13, 1985-1 C.B. 184 also may support the trust taking the grantor's transferred "cost" basis in the promissory note, *see infra* Part IV.B.3, because the IRS did not rule that the grantor had a zero basis in the self-created promissory note (and thus in any event would not have had a cost basis of $40 on the subsequent sale).

than the trust's cost basis.[25] Further, if the selling spouse sells loss property—property with a basis greater than FMV—to the trust, the trust takes the selling spouse's basis and not the lower FMV.[26] Thus, Section 1041's transferred basis provision preserves any inherent gain or loss on transfers between spouses for income tax purposes, rather than preserving the gain but eliminating any loss on a gift subject to the basis provisions of Section 1015(a).[27]

Section 1041's nonrecognition rule requires that, for income tax purposes, a sale of property from one spouse to a grantor trust treated as wholly owned by the other spouse should not be a realization event within the meaning of Section 1001(a), and should be treated as a nontaxable gift excluded from gross income pursuant to Section 102. The spousal grantor trust should take the selling spouse's basis in property transferred to the trust, without adjustment for inherent loss or assumed liabilities, if any,[28] and the selling spouse should take the trust's basis in the consideration received on the sale. The transaction thus should be viewed as two separate transfers: (1) a transfer of property from the selling spouse to the trust, with the trust taking the selling spouse's basis under Section 1041(b)(2); and (2) a transfer of cash and an installment note from the trust to the selling spouse, with the selling spouse taking the trust's basis in the consideration received under Section 1041(b)(2).

Saving the discussion of the trust's basis in its self-made promissory note for later in this article, in any event the selling spouse should be treated as receiving a transferred basis from the spousal grantor trust for any property received in consideration on the sale, and of any subsequent installment payments on the note. For example, if payments on the installment note are paid in property other than cash, the selling spouse should acquire the trust's basis in the property, even if the selling spouse otherwise may have received a basis equal to the face amount of the note. If both spouses are alive, the acceptance of appreciated property as payment on the note should not trigger gain to either the spousal

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[25] Treas. Reg. § 1.1041-1T(a), Q&A 2, Ex. 2 (sale in ordinary course of business from one spouse's sole proprietorship to the other spouse is subject to the rules of § 1041).

[26] Treas. Reg. § 1.1041-1T(d), Q&A 11.

[27] *See* I.R.C. § 1015(e) (providing that property acquired by gift between spouses within I.R.C. § 1041(a) is determined under I.R.C. § 1041(b)(2), and not I.R.C. § 1015).

[28] A transferor spouse's recognition of gain for liabilities in excess of basis under § 1041(e) applies to "the transfer of property in trust." Read in conjunction with § 1041(a), § 1041(e) should apply to a transfer of property from an individual "in trust for the benefit of" a spouse. This raises the question of whether the selling spouse's transfer to the spousal grantor trust is a transfer directly to the spouse for income tax purposes, or "in trust." However, because the spousal grantor trust would not be for the benefit of the grantor spouse, it would appear that in any event § 1041(e) should not apply and the transaction should be analyzed as a transfer from one spouse directly to the other.

grantor trust or the selling spouse, and should continue to be viewed as the transfer of property with varying bases between spouses subject to Section 1041.

E. Taxation of Interest Payments

Section 1041 applies only to property transfers between spouses, and not to all potentially taxable transactions between spouses. For example, it does not apply to compensation for services rendered by a spouse,[29] nor to the payment of interest compensating for the delay of a payment otherwise within Section 1041.[30]

In *Gibbs v. Commissioner*, the Tax Court considered whether a taxpayer is required to include the interest portion of installment payments received from a former spouse in exchange for the taxpayer's interest in a business.[31] The court acknowledged that in the typical debtor-creditor relationship, interest is treated differently from principal for federal tax purposes, and that although principal repayments do not constitute income to the lender, interest payments do. Noting that Section 1041 does not provide for the exclusion of income,[32] the Tax Court analyzed Section 1041 as a nonrecognition provision that deferred recognition of gain or loss through its transferred basis provisions. The Tax Court stated that it saw no reason to treat interest payments for transactions subject to Section 1041 differently from other situations taxing interest income on payments otherwise subject to nonrecognition provisions, such as Section 104(a)(2) (damages for personal injury) and Section 1033 (condemnation awards). As a result, the taxpayer was required to include in income stated interest paid by a former spouse pursuant to a divorce decree.

In the spousal grantor trust sale context, *Gibbs* suggests that the selling spouse should include interest payments received on the note in gross income because the payment of interest is not within Section

29 Treas. Reg. § 1.1041-1T(a), Q&A 4.

30 *See*, *e.g.*, Cipriano v. Comm'r, T.C. Memo. 2001-157, 81 T.C.M. (CCH) 1049 (2001) (ruling that interest payments received in connection with division of marital property were properly includable in income). *See also* I.R.C. § 102(b)(1) (exclusion of gifted property from gross income does not apply to income from the gifted property), *See also supra* note 13.

31 Gibbs v. Comm'r, T.C. Memo. 1997-196, 73 T.C.M. (CCH) 2669 (1997). The taxpayer had stipulated that a portion of each installment payment was properly allocated to principal and interest.

32 However, § 1041 appears to have been intended to apply to discharge of indebtedness income. Rep. No. H.R. 98-432, pt. 2, at 492 (1984) (Conf. Rep.). Pursuant to I.R.C. § 102, gross income does not include discharge of indebtedness income if such discharge is the result of a gift. *See*, *e.g.*, Juister v. Comm'r, T.C. Memo. 1987-292, 53 T.C.M. (CCH) 2669 (1987).

1041's nonrecognition provisions. However, the spousal grantor trust (and thus the grantor spouse) may receive an off-setting deduction for the interest expense if, for example, the promissory note was issued in exchange for investment property,[33] subject to any applicable adjustments.[34]

Ordinarily, if a note provides for the accrual of interest and a lump-sum balloon payment of all outstanding principal and accrued but unpaid interest at the end of the note's term, the holder of the note may be required to recognize interest currently regardless of the tax method of accounting employed under the OID rules.[35] It is unclear, however, whether the OID rules would apply to require a cash method selling spouse to recognize interest income currently on an accrual-only note received in a spousal grantor trust installment sale. If the promissory note accrues interest each year at the A.F.R. so that all accrued but unpaid interest and principal is due at the end of the note's term, Section 7872 would not apply because the note provides for adequately stated interest.[36] Although the OID rules generally appear to apply to loans between spouses,[37] they do not include rules to determine the issue price for gratuitously issued debt instruments.[38] Similarly, the rules applicable to debt instruments issued in exchange for property do not apply because Section 1041 treats an installment sale to a spousal grantor trust as a gift—not a sale or exchange of property—between spouses

33 *See*, *e.g.*, Armacost v. Comm'r, T.C. Memo. 1998-150, 75 T.C.M. (CCH) 2177 (1998) (allowing deduction for interest payment on promissory note issued to former spouse in exchange for community share of investment property). *See also* Seymour v. Comm'r, 109 T.C. 279, 286 (1997) (providing that taxpayer may deduct interest payments on indebtedness payable to former spouse if properly characterized as investment interest, passive activity interest, or qualified residence interest, and not personal interest under § 163(h)(1)).

34 *See* I.R.C. §§ 56(b)(1)(C) (adjustment for AMT purposes), 163(d) (limitations on investment interest deduction for noncorporate taxpayers).

35 I.R.C. § 1272(a). *See also* Steve R. Akers & Philip J. Hayes, *Estate Planning Issues with Intra-Family Loans and Notes*, 38 ACTEC L. J. 51, 89 (2012).

36 Section 7872 should also be inapplicable if the sale is negotiated at arm's length and free from donative intent. *See* PLR 9644053 (Aug. 1, 1996) (ruling that § 7872 would not apply to property transfers negotiated at arm's length between spouses incident to divorce).

37 The special rule treating a husband and wife as one person under I.R.C. § 1271(a)(2)(D)(iii) only applies for purposes of § 1272(a)(2)(D)'s exception for de minimis loans, and does not generally apply to disregard loans between spouses for purposes of the OID rules. *See* Treas. Reg. § 1.1272-1(a)(2).

38 Section 1273(b)(2) provides that for debt instruments that are not issued for property and that are not publicly traded, the issue price is the price first paid by the first buyer of the debt instrument. An installment note issued to a selling spouse in a spousal grantor trust sale is not issued for property by application of § 1041(a), but there is no price "paid" by the selling spouse because § 1041(b)(1) requires that the note be treated as a gift.

for income tax purposes.[39] If the OID rules do not apply to a gratuitous note transferred between spouses, the selling spouse may be able to include interest income on the note according to his or her tax method of accounting.[40] Therefore, although it is not settled, it may be possible to delay inclusion of interest income until interest is actually paid if the selling spouse uses the cash method of accounting and the promissory note provides for the accrual of interest and a lump sum balloon payment at the end of the note's term.

With a note that accrues interest, the spousal grantor trust (and thus the grantor spouse) would not be able to take a deduction under the cash method of accounting until the interest is actually paid at the end of the note's term.[41] In addition, Section 267(a)(2) prevents a grantor spouse who uses the accrual method of accounting from deducting any interest expense until it is included in income by a selling spouse using the cash method. It thus should not be possible for the spousal grantor trust to take investment interest deductions ratably over the life of the loan, but defer inclusion in the selling spouse's income until paid at the end of the term.

In contrast, with a traditional grantor trust sale there is no taxation of interest income (or potential deduction) for interest expense related to indebtedness used to finance the acquisition of property purchased by the grantor trust. Because the transaction is wholly-ignored for income tax purposes under Revenue Ruling 85-13, there is no inclusion of interest income or recognition of gain on principal payments. The grantor and the grantor trust are viewed as the same taxpayer for all income tax

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39 I.R.C. § 1273(b)(4) (issue price equals stated redemption price at maturity for debt instruments issued in exchange for property not covered by § 1273(b)(1)-(3) or § 1274); Treas. Reg. § 1.483-1(c)(3)(i) (providing that § 483 does not apply to any transfer of property subject to § 1041 (relating to transfers of property between spouses or incident to divorce)); Treas. Reg. § 1.1274-1(b)(3)(iii) (excepting any debt instrument issued in exchange for property subject to § 1041 as a transfer between spouses from application of § 1274). Similarly, § 1273(b)(4) (providing that the issue price for certain debt instruments issued for property equals the redemption price, *i.e.*, the debt instrument does not have OID) would not apply because the note issued from the spousal grantor trust is treated as a gift from the grantor spouse to the selling spouse under § 1041.

40 *See* I.R.C. § 1273(b)(4) (issue price equals stated redemption price at maturity—so no OID—for debt issued in exchange for property, unless § 1274 applies); Treas. Reg. § 1.1274-1(b)(3)(iii) (excepting any debt instrument issued in exchange for property subject to § 1041 as a transfer between spouses from application of § 1274). Although the unstated interest rules of § 483 apply to sales of property described in § 1273(b)(4), the regulations provide that § 483 does not apply to sales of property between spouses subject to § 1041. *See* I.R.C. § 483(d)(1); Treas. Reg. § 1.483-1(c)(3)(i).

41 *See*, *e.g.*, Rev. Rul. 77-135, 1977-1 C.B. 133 (cash basis taxpayer may not deduct accrued but unpaid interest added to principal loan balance until actually paid); Rev. Rul. 73-482, 1973-2 C.B. 44 (cash method taxpayer may not deduct accrued but unpaid interest added to principal balance of loan until actually paid).

purposes, and so the grantor is both the payor and payee of interest on the promissory note. The payment of interest as compensation for the delayed transfer of property should not be recognized for federal tax purposes if the same person is treated as having the right to receive the property and the obligation to transfer it.[42] This rationale, however, does not apply to the spousal grantor trust sale because the selling spouse and the grantor spouse are recognized as two distinct persons for federal income tax purposes, and the payment of interest does not qualify for nonrecognition treatment under Section 1041.

F. Is the Payment of Interest Required?

The discussion above demonstrates that interest payments made on debt obligations issued in connection with installment sales of property to a spousal grantor trust are not within the scope of Section 1041, and thus should be taxable to the selling spouse (and possibly deductible by the grantor spouse). However, the Code's imputed interest rules for income tax purposes, Sections 483 and 1274, do not apply to sales of property between spouses, so an installment obligation with inadequate interest should not impute interest to a lending spouse under these provisions.[43] Hence the question: are interest payments on an installment sale to a spousal grantor trust required?

1. *Imputed Interest Rules: Sections 483, 1274, and 7872*

Although the spousal grantor trust is disregarded and viewed as the grantor spouse for income tax purposes, it is not viewed as the grantor spouse for gift tax purposes—the trust is a separate entity under the gift tax provisions located in Subtitle B, Chapter 12, of the Internal Revenue Code.[44] Section 7872 of the Code is a catch-all provision providing rules for below-market interest loans and the related effects for other subtitles of the Code, including income tax provisions (Subtitle A) and gift tax provisions (Subtitle B).[45] If a loan does not bear interest at the AFR, Section 7872 imputes interest annually to the lender, and creates a deemed transfer of property from the lender to the borrower. The treatment of the deemed transfer from the lender to the borrower is

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42 *See* Rev. Rul. 85-13, 1985-1 C.B. 184 ("A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction.").

43 Treas. Reg. § 1.483-1(c)(3)(i); Treas. Reg. § 1.1274-1(b)(3)(iii); Prop. Treas. Reg § 1.7872-11(c).

44 Sections 483 and 1274 are located under the income tax provisions of the Code, located at Subtitle A, Chapter 1.

45 Section 7872 is under Subtitle F, Chapter 80, Subchapter C of the Code, entitled "Provisions affecting more than one subtitle," and applies for purposes of "this title," or the entire Internal Revenue Code.

governed by the context of the lending arrangement.[46] For example, the deemed transfer of foregone interest would be treated as a taxable gift for a loan between a parent and a child, and as compensation income for a loan between an employer and employee.[47]

In similar fashion to the income tax rules, Section 7872 treats a husband and wife as one person, and loans between spouses are not subject to its below-market interest rate rules.[48] So that section would neither impute interest on a loan between spouses to the lending spouse, nor create a deemed gift of foregone interest to the borrowing spouse.

Section 7872, however, does not treat a spousal grantor trust as the grantor spouse for purposes of the below-market interest rate rules. As a result, the below-market interest rate rules will impute interest to the selling spouse, and a deemed transfer of foregone interest to the spousal grantor trust. Section 7872, however, expressly does not apply to any loan to which Section 483 (imputed interest on deferred payments under contracts for the sale or exchange of property) or Section 1274 (imputed interest for debt instruments given in consideration for the sale or exchange of property) applies.[49]

On their face, Sections 483 and 1274 apply to installment sales of property between spouses. Section 1041, however, mandates that property exchanges between spouses are nontaxable gifts.[50] The regulations recognize this treatment for income tax purposes and exclude exchanges of property between spouses that fall within the nonrecognition provisions of Section 1041 from Section 483 and Section 1274's imputed interest rules, so there is no imputed interest on loans between spouses.[51] This could result in two interpretations: (1) Sections 483 and 1274 do not apply to a spousal grantor trust sale via the regulations, Section 1041, and the grantor trust rules, so Section 7872 applies to the spousal grantor trust sale for both income and gift tax purposes; or (2) Sections 483 and 1274 apply on their face to a spousal grantor trust sale, so Section 7872 does not apply to the spousal grantor trust sale, at least for income tax purposes.[52] As will be seen below, under either scenario the

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[46] H.R. REP. NO. 98-861, at 1012 (1984).

[47] *Id.*

[48] I.R.C. § 7872(f)(7) (husband and wife treated as one person for below-market interest rate rules); Prop. Treas. Reg § 1.7872-11(c) (all loans between a husband and wife are disregarded for purposes of § 7872).

[49] I.R.C. § 7872(f)(8).

[50] I.R.C. § 1041(a), (b).

[51] Treas. Reg. § 1.483-1(c)(3)(i) (§ 483 does not apply to any transfer of property subject to § 1041); Treas. Reg. § 1.1274-1(b)(3)(iii) (§ 1274 does not apply to any debt instrument issued in consideration for a transfer of property subject to § 1041).

[52] I.R.C. § 7872(f)(8) ("This section shall not apply to any loan to which section 483, 643(i), or 1274 applies."). *See*, *e.g.*, Frazee v. Comm'r, 98 T.C. 554, 585-86 (1992) (holding

gift tax result should be the same: a note bearing interest at less than the AFR would create a deemed taxable gift of foregone interest from the selling spouse to the spousal grantor trust, which would cause the selling spouse to be treated as a transferor to the trust for gift and estate tax purposes.

2. *Scenario 1: Section 7872 Applies for Income and Gift Tax Purposes*

Under the first scenario, if a promissory note that bears interest at less than the AFR is given as consideration in a spousal grantor trust sale, Section 7872 will impute interest to the selling spouse[53] and create a deemed gift of the present value of the foregone interest from the selling spouse to the spousal grantor trust.[54] Payment of interest between spouses is not excluded under the income tax rules, so the selling spouse would recognize imputed interest income, although the spousal grantor trust may receive a corresponding deduction.[55] In addition, neither Section 7872 nor the gift tax rules contain any provision that treats the spousal grantor trust as the grantor spouse for gift tax purposes. As a result, any deemed gift of the present value of the foregone interest under the note would be a taxable gift from the selling spouse to the spousal grantor trust that would not qualify for the gift tax marital deduction. The deemed taxable gift would also cause the selling spouse to be a transferor to the trust for gift and estate tax purposes.

In this example, Section 7872 will only apply for income tax purposes if it is determined that neither Section 483 nor Section 1274 applies by virtue of the grantor trust rules, Section 1041, and the regulations.[56] As discussed above, under the grantor trust rules and Revenue Ruling 85-13, the spousal grantor trust is disregarded and viewed as the grantor spouse for income tax purposes. Thus, for income tax purposes, the transaction is not viewed as the sale or exchange of

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that where § 483(e) applies for income tax purposes, § 7872 continues to apply for gift tax purposes). *See also* Akers & Hayes, *supra* note 35, at 123 (excellent discussion on how, despite the plain language of the statute, courts and the IRS interpret § 7872(f)(8) to say that the below-market loan rules do not apply to any loan "to the extent that" § 1274 or § 483 applies).

53 I.R.C. § 7872(a)(1)(B), (a)(2).

54 I.R.C. § 7872(b)(1), (d)(2).

55 Section 7872(a)(1)(B) creates a deemed transfer of foregone interest from the borrower to the lender.

56 I.R.C. § 7872(f)(8) (§ 7872 does not apply to any loan to which § 483 or § 1274 applies); Treas. Reg. § 1.483-1(c)(3)(i) (§ 483 does not apply to any transfer of property subject to § 1041); Treas. Reg. § 1.1274-1(b)(3)(iii) (§ 1274 does not apply to any debt instrument issued in consideration for a transfer of property subject to § 1041).

property, but as gifts from one spouse to the other.[57] Because there is no sale or exchange of property for income tax purposes, Sections 483 and 1274 will not apply, and a spousal grantor trust sale should be governed by Section 7872 for both income and gift tax purposes.[58]

In addition, the regulations further clarify that Sections 483 and 1274 do not apply to property exchanges between spouses covered by Section 1041.[59] Deference to a regulation may be appropriate where it carries out Congressional intent in a proper manner and in accordance with the statute's plain language, origin, and purpose.[60] These regulations appear to be a correct and consistent interpretation of the income tax laws because, for income tax purposes, Section 1041 mandates that exchanges of property between spouses be treated as nontaxable gifts of property.[61]

In the ordinary case of an installment obligation between a husband and a wife, it does not matter whether Section 7872 applies for income tax purposes because even if it applies, it will not impute interest to the lending spouse because a husband and wife are treated as one person and the loan is ignored.[62] In the spousal grantor trust sale context, however, it makes a difference because the selling spouse and the spousal grantor trust are not treated as husband and wife for purposes of Section 7872, and thus inadequate interest on the installment obligation may cause the selling spouse to recognize interest income, although there may be a corresponding deduction for the spousal grantor trust.[63] Although it may be arguable that Section 483 and Section 1274 apply to the spousal grantor trust sale for income tax purposes, and thus Section 7872 does not apply to create taxable imputed interest, the IRS has ruled that Section 483 and Section 1274 do not apply to transactions governed by Section 1041 by reason of the regulations, and thus Section 7872 applies.

In PLR 9644053,[64] the IRS considered whether Section 483, Section 1274, or Section 7872 applies to recharacterize as interest any portion of

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57 I.R.C. § 1041(b).

58 I.R.C. §§ 483(c) (applies to deferred payment contracts for the sale or exchange of property), 1274(c) (applies to debt instruments issued in exchange for property).

59 Treas. Reg. § 1.483-1(c)(3)(i) (§ 483 does not apply to any transfer of property subject to § 1041); Treas. Reg. § 1.1274-1(b)(3)(iii) (§ 1274 does not apply to any debt instrument issued in consideration for a transfer of property subject to § 1041).

60 *See* Nat'l Muffler Dealers Assn. v. United States, 440 U.S. 472, 476-77 (1979).

61 I.R.C. § 1041(b).

62 I.R.C. § 7872(f)(7) (husband and wife treated as one person for below-market interest rate rules); Prop. Treas. Reg. § 1.7872-11(c) (all loans between a husband and wife are disregarded for purposes of § 7872).

63 Section 7872(a)(1)(B) creates a deemed transfer of interest from the borrower to the lender.

64 PLR 9644053 (Aug. 1, 1996).

payments made pursuant to an annuity agreement that was entered into in connection with a marital settlement agreement.[65] The IRS determined that although Sections 483 and 1274 apply to a broad class of deferred payments given in exchange for property, they do not apply to deferred payments issued in connection with a transfer of property subject to Section 1041. Because the annuity agreement (and any annuity payments thereunder) were incident to divorce and subject to Section 1041, Sections 483 and 1274 do not apply. In considering application of Section 7872 to the annuity payments, the IRS noted that a husband and wife were treated as one person for purposes of that section, but did not base its conclusion on this section. Instead, the IRS analyzed the transfer and determined that it was negotiated at arm's length by a husband and wife incident to divorce, was not motivated by donative intent, provided no extension of credit intended to provide an economic benefit to the donee, and did not have a principal purpose to avoid federal tax. The IRS concluded that they did not believe Section 7872 was intended to apply to transactions like the one at issue, and therefore the annuity payments would not be subject to that section's below-market interest rules.

If the IRS considered a similar situation in the context of a spousal grantor trust sale, it likely would not reach the same conclusion excepting the transaction from Section 7872 because the same policy considerations would not exist. Nevertheless, application of Section 7872 to a spousal grantor trust sale may actually provide a benefit because the AFR's gift tax safe harbor rate clearly would apply to the sale. As discussed in the following section, reasonable minds may differ as to whether Section 7872's safe harbor rate for gift tax purposes applies to a transaction that is governed by Sections 483 or 1274. In any event, the better practice is to include a rate of interest at least equal to the AFR to allow the spousal grantor trust to take a deduction for any interest payments actually made, and to help prevent a deemed taxable gift by the selling spouse for gift tax purposes under Section 7872.

3. *Scenario 2: Sections 483 or 1274 Apply for Income Tax Purposes*

Turning to the second scenario, subject to specific limitations, Sections 483 and 1274 on their face apply to a spousal grantor trust sale, but

65 *See also* PLR 8645082 (Aug. 14, 1986) (ruling that, prior to issuance of final regulations, § 483 would not apply to a promissory note issued in exchange of property by spouses in connection with a marital settlement agreement because under § 1041 a property transfer between spouses is not treated as a sale or exchange, and § 7872 further would not apply because this transaction is an arm's-length negotiation with no donative intent).

no interest would be imputed to the selling spouse by reason of the regulations, Section 1041, and the grantor trust rules. Based on the plain language of Section 7872(f)(8), if Sections 483 and 1274 apply for income tax purposes, Section 7872 is entirely inapplicable for income or gift tax purposes. Although an installment obligation bearing inadequate interest might not impute interest to the selling spouse under Sections 483 or 1274, any deemed taxable gift for the below-market interest rate may be measured at a market rate, rather than the AFR, because Section 7872's safe harbor interest rate would not apply for gift tax purposes.[66] The IRS, however, has argued—successfully—that Section 7872 does not apply to a below-market loan *to the extent that* Section 483 or Section 1274 applies, such that it will not apply to impute interest under the income tax rules otherwise governed by Section 483 or Section 1274, but will apply for gift tax purposes to create a deemed gift of foregone interest as measured by the AFR.

This scenario was considered in *Frazee v. Commissioner*, 98 T.C. 554 (1992), where the Tax Court held for the IRS that although Section 7872 would not apply to a below-market installment obligation governed by Section 483(e) for income tax purposes, it would apply for gift tax purposes. The transaction at issue involved a sale of agricultural use property from a married couple to their children in exchange for an installment promissory note bearing interest at 7%, which was substantially lower than the AFR at the time. Section 483(e)'s safe harbor interest rate was 6%, so there was no imputed interest on the sale for income tax purposes. The taxpayers argued that because the note bore interest that met Section 483(e)'s safe harbor rate, there was adequate interest and no taxable gift for gift tax purposes. The IRS asserted that Section 483(e) did not apply for gift tax purposes and that the methodology of Section 7872 properly should be used to value the deemed taxable gift relating to the below-market interest rate. In the alternative, the IRS argued that the promissory note should be valued at its fair market value. The court agreed with the IRS that Section 483(e) did not apply for gift tax purposes. The court also agreed with the IRS's primary position that Section 7872 nevertheless applied to the transaction for gift tax purposes. In analyzing the scope of Section 7872, the court stated that by enacting Section 7872, "Congress displaced the traditional fair market methodology of valuation of below-market loans by substituting a discounting methodology."[67] The court, however, openly recognized that if the value of the note was determined against a fair market interest rate rather than the lower AFR required under Section 7872—the alternative argument put forth by the IRS—there would be a larger tax-

[66] *See* Akers & Hayes, *supra* note 35, at 129.
[67] Frazee v. Comm'r, 98 T.C. 554, 589 (1992).

able gift than the one determined using the AFR. In the words of the court, "We find it anomalous that the respondent urges as her primary position the application of section 7872, which is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept."[68] Thus, by accepting the IRS's primary position that Section 7872 applies for gift tax purposes, even if Section 483 applies for income tax purposes, under current case law the gift tax safe harbor rate for an installment sale of property is equal to the AFR.[69]

Thus, under *Frazee*, if a selling spouse sells property to a spousal grantor trust in exchange for an installment promissory note, Section 7872 should apply for gift tax purposes, even if it does not apply for income tax purposes. Although Section 7872(f)(7) treats a husband and wife as one person for purposes of the below-market interest rate rules, as previously discussed, neither Section 7872 nor any gift tax provision exists to treat the spousal grantor trust as the as the grantor spouse for purposes of Section 7872's below-market interest rate rules or the gift tax marital deduction. So under this scenario, it is advisable to include interest at least equal to the applicable federal rate to help prevent the selling spouse from being treated as making a gratuitous transfer of property to the spousal grantor trust for federal transfer tax purposes.

4. *Application of* Frazee *to Installment Sale to Spousal Grantor Trust*

Neither *Frazee* nor PLR 9535026, however, involved a transaction between spouses governed by Section 1041. If the IRS follows its reasoning in PLR 9644053, discussed *supra*, then Section 483 and Section 1274 would not apply because the spousal grantor trust sale is governed by Section 1041, and therefore Section 7872 should apply for both income and gift tax purposes. Under this scenario, use of the AFR in a spousal grantor trust sale should avoid a deemed taxable gift on the sale, at least with respect to any argument relating to the inadequacy of the interest rate.[70]

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68 *Id* at 590.

69 The IRS has applied § 7872 to installment sales of property for gift or income tax purposes in private letter rulings, but the facts have generally been distinguishable from those involved with an installment sale to a spousal grantor trust. *See*, *e.g.*, PLR 9644053 (discussing application of § 7872 for income tax purposes to an annuity agreement entered into in connection with a marital settlement agreement); PLR 9535026 (May 31, 1995) (ruling that § 7872 applied for gift tax purposes to installment note given in consideration for a sale of property by a beneficiary to a trust treated as wholly-owned by the beneficiary under the grantor trust rules); PLR 9408018 (Nov. 29, 1993) (ruling that § 7872, not § 1274, applied to installment sale of stock for gift tax purposes).

70 It further should be noted that the court in *Frazee* considered the gift elements of an installment sale of property in two parts: (1) whether the principal amount of the note

If the IRS does not follow this argument, however, it may reopen the argument that because the installment grantor trust sale is governed by Section 483 or Section 1274, Section 7872 does not apply for any purpose and the installment promissory note issued in the sale would create a taxable gift to the extent it did not bear a fair market interest rate. Although this could be a reasonable conclusion, the IRS would have to argue (1) that its own regulations stating that Section 483 and Section 1274 do not apply to Section 1041 transactions are insufficient to overcome Congressional intent and the plain language of Section 7872 to cause those sections to be inapplicable in the spousal grantor trust sale context; and (2) that its primary position taken, and accepted, in *Frazee* is incorrect and Section 7872(f)(8) should operate to make that section inapplicable to a spousal grantor trust sale for both income and gift tax purposes, such that a market rate of interest must be used to value the installment obligation for gift tax purposes. These would appear to be two very big hurdles for the IRS to overcome to successfully argue that a market rate of interest, rather than the AFR, should be used as the benchmark to determine whether the selling spouse made a taxable gift to the spousal grantor trust by reason of an inadequate interest rate. Nevertheless, it is possible the argument could be made on policy grounds, but a new case or ruling would have to be made to overturn or distinguish *Frazee*.

Based on *Frazee*, there is a reasonably supportable position that Section 7872 would apply—for gift tax purposes—to an installment sale to a spousal grantor trust whether or not it is governed by Section 483 or Section 1274 for income tax purposes. Thus, if the note failed to bear interest at the AFR, there would be a deemed taxable gift from the selling spouse to the spousal grantor trust, which would cause the selling spouse to be a transferor to the trust for gift tax purposes. If the note bears interest at the AFR, however, there should be no taxable gift for inadequate interest (and no imputed interest), even if the rate is less than the fair market value rate.

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was equal to the fair market value of the property sold; and (2) whether the note bore adequate interest to prevent a deemed taxable gift for gratuitous lending of money. *Frazee*, 98 T.C. at 579. This helps support the argument that if the principal amount of an installment promissory note given as consideration in a spousal grantor trust sale is equal to the fair market value of the property sold, there should be no taxable gift so long as the note bears interest at the AFR. *See also* PLR 9535026 (installment note bearing interest at the AFR would not create a deemed taxable gift, assuming that the principal balance of the note was equal to the fair market value of the property sold); PLR 9408018 (no taxable gift where promissory note given in exchange for stock bears interest at the AFR, and for federal gift tax purposes the fair market value of the note will be the stated principal amount).

Further, although not directly decided in *Frazee*, the scope of Section 7872 should extend the AFR safe harbor rate for estate tax purposes, such that a note that includes interest at the then-applicable AFR should not be viewed as made for less than an adequate and full consideration for estate tax purposes.[71] Thus, under either scenario above, a note bearing interest at the AFR should prevent a deemed taxable gift from the selling spouse to the spousal grantor trust under Section 7872, and it should not be required to bear a higher market rate to avoid a taxable transfer to the trust for estate tax purposes.

In summary, a note bearing interest below the AFR likely would result in a deemed gift from the selling spouse to the trust under the below-market rules of Section 7872. It is therefore advisable to include interest at a rate that is at least equal to the AFR to help prevent the selling spouse from being treated as making a gratuitous transfer of property to the spousal grantor trust for federal transfer tax purposes.

IV. Income Tax Treatment upon the Death of Either Spouse

The preceding analysis presumably governs the income tax treatment of a spousal grantor trust sale while both spouses are living. Our next question is whether the income tax implications of the spousal grantor trust sale change upon the death of a spouse, or whether the transaction continues to be subject to Section 1041's nonrecognition treatment.

An installment sale of property to a spousal grantor trust typically involves the receipt by the selling spouse of an installment note. The income tax treatment of the installment note upon the death of the selling spouse or the grantor spouse has not been definitely resolved. However, an examination of relevant authority in other contexts supports the position that no gain should be recognized on the death of either spouse while the note is outstanding.

A. Death of Selling Spouse

If the installment note is outstanding on the death of the selling spouse, the note should be an asset included in the selling spouse's estate for estate tax purposes that receives a stepped-up basis at the selling spouse's death pursuant to Section 1014.[72] In general, the basis in prop-

[71] *See* I.R.C. § 7872(i)(2) (providing that under regulations prescribed by the Secretary, any term loan made with donative intent shall be taken into account for estate tax purposes in a manner consistent with the rules applicable to below-market term loans for gift tax purposes).

[72] Although the note should not be viewed as an installment obligation reportable under § 453's installment method, transfers of installment obligations at death are not a recognition event. I.R.C. § 453B(c).

erty acquired from a decedent is equal to the fair market value on the date of the decedent's death or, in the event of an election under Section 2032, the alternate valuation date.[73] The stepped-up basis provisions of Section 1014 do not apply to property constituting income in respect of a decedent ("IRD") under Section 691.[74]

IRD generally refers to a decedent's items of gross income that were not properly included in gross income prior to or in the year of the decedent's death.[75] If an item is properly excluded from gross income, it is not IRD.[76] Items constituting IRD include installment obligations reportable by the decedent on the installment method under Section 453.[77] Section 691(a)(4) refers to an "installment obligation which remains uncollected by a decedent (or a prior decedent) and which was originally acquired in a transaction the income from which was properly reportable by the decedent on the installment method under section 453."[78]

As discussed above, a sale of property by the selling spouse to a spousal grantor trust in exchange for a promissory note is not recognized as a sale for federal income tax purposes and the exchange of property is treated as a gift between spouses.[79] As a result, a sale of property from one spouse to a grantor trust treated as wholly owned by the other spouse for income tax purposes should not be a realization event within the meaning of Section 1001(a), and should be treated as a nontaxable gift excluded from gross income pursuant to Section 102.[80]

Because Sections 1041 and 102 require that payments on the note to the selling spouse be treated as nontaxable gifts excluded from gross income, the note should not be an item of IRD at the selling spouse's death. Further, the sale to the spousal grantor trust should not result in a "sale or other disposition" recognized for federal income tax purposes, and thus the transaction should not be a disposition of property constituting an "installment sale" within the meaning of Section 453(b) that is reportable under the installment method.[81] Because the promissory

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[73] I.R.C. § 1014(a).

[74] I.R.C. § 1014(c).

[75] Treas. Reg. § 1.691(a)-1(b).

[76] Treas. Reg. § 1.691(a)-1(d).

[77] I.R.C. § 691(a)(4).

[78] Treas. Reg. § 1.691(a)-5

[79] I.R.C. § 1041(b)(1).

[80] In contrast, a transfer of property to a trust that is not a "grantor trust" for income tax purposes is a "sale or other disposition of property" within the meaning of § 1001(a). *See* Treas. Reg. § 1.1001-2(c), Ex. 6 (regarding amount of gain realized on transfer of property to a non-grantor trust in exchange for cash and assumption of liabilities).

[81] *See also* Elliot Manning & Jerome M. Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements*, 24 TAX MGMT. EST.,

note should not constitute IRD within the meaning of Section 691, it therefore should qualify for the stepped-up basis provisions of Section 1014(a).[82] Any gain or loss on amounts received on the promissory note after the selling spouse's death should be determined with respect to the basis in the property as determined under Section 1014 as of the date of the selling spouse's death.

> In sum, on the death of the selling spouse, the promissory note should be treated as follows:
>
> 1. The note should be treated as a nontaxable gift of property under Sections 1041 and 102 that is excluded from the selling spouse's gross income and not reportable under Section 453's installment method.
> 2. The selling spouse's heirs or beneficiaries should receive a basis in the promissory note as determined under Section 1014(a).
> 3. Since the fair market value of the promissory note is presumed to be equal to its outstanding balance for estate tax purposes, the selling spouse's heirs or beneficiaries should not recognize gain on the receipt of principal payments under the note.[83]

B. Death of the Grantor Spouse

A different set of questions arise upon the death of the grantor spouse, which causes the trust to be treated as a separate entity for in-

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GIFTS & TR. J. 1, 3 (1999) (discussing how promissory note issued in traditional grantor trust sale should receive stepped-up basis at death and is not IRD reportable under the installment method).

82 For estate tax purposes, the fair market value of a promissory note "is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless." Treas. Reg. § 20.2031-4. In particular, the regulation provides that if the note's value is reported at less than face value and accrued interest, "satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible . . . and that any property pledged . . . as security is insufficient to satisfy the obligation." If the presumption is applied to the promissory note held by the selling spouse at death, for example, because the executor did not rebut the regulatory presumption, there should be no gain upon receipt of principal payments by the selling spouse's successor. It is possible, however, that the IRS could rebut the presumption on audit and claim that the note has a lower (or potentially higher) value for estate tax purposes.

83 *Id.* If the fair market value of the note is less than face value and thus bears a discount, the selling spouse's heirs or beneficiaries may be required to recognize income for amounts received in excess of fair market value. *See, e.g.*, Hatch v. Comm'r, 190 F.2d 254, 256 (2d Cir. 1951).

come tax purposes upon the grantor spouse's death.[84] As discussed below, these questions involve (1) the timing of the deemed gift of the installment note to the selling spouse; (2) the selling spouse's basis in the note received from the spousal grantor trust; and (3) the income tax treatment of the conversion of the trust from a grantor trust to a non-grantor trust for income tax purposes at the grantor spouse's death.

1. *Timing of Transfer of Note to Selling Spouse for Tax Purposes*

Relevant authorities in the gift and income tax area support the proposition that the exchange of an installment note for property is a completed transfer at the time that the spousal grantor trust sale becomes binding under local law and is capable of valuation. Thus, the deemed gift of the installment obligation from the grantor spouse to the selling spouse prescribed by Section 1041 should occur at the same time. If the gift is complete at the time that the installment sale to the spousal grantor trust is made, then subsequent installment payments made in accordance with the terms of the sale should not be viewed as new "gifts" or transfers to the selling spouse each time they are made. As discussed below, the determination of a completed transfer for gift and income tax purposes will in turn depend on the facts and circumstances surrounding the sale and its enforceability under local law.[85]

(a) *Gift Tax Treatment—Completion of Gift*

Section 1041(b)(1) specifically provides that the transfer of an installment note in exchange for property from one spouse to another is treated as a gift for income tax purposes. If the selling spouse has received an installment obligation by gift from the other spouse, the gift is made at the time that the installment obligation is binding. In Revenue Ruling 69-347, the IRS concluded that, for gift tax purposes, installment payments made pursuant to a premarital agreement that became effective upon marriage are treated as made at the time the agreement be-

[84] Commentators have expressed the view that assets held by a grantor trust at the grantor's death should receive a stepped-up basis under § 1014. *See*, Jonathan G. Blattmachr, Mitchell M. Gans & Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of Grantor's Death*, 97 J. TAX'N 149, 149-50 (2002); Joy Elizabeth Hodge, *On the Death of Dr. Jekyll—The Disposition of Mr. Hyde: The Proper Treatment of an Intentionally Defective Grantor Trust at the Grantor's Death*, 29 TAX MGMT. EST., GIFTS & TR. J. 275, 276, 297-300 (2004). The IRS has announced that this is an area under study and for which private letter rulings or determination letters will not be issued. Rev. Proc. 2019-3, 2019-1 I.R.B. 130 § 5.01(8).

[85] *See* Harris v. Comm'r, 178 F.2d 861, 865 (2d. Cir. 1949), *rev'd on other grounds*, 340 U.S. 106 (1950) (noting distinction for transaction made for valid consideration under state law classified as gift by statute for federal tax purposes).

comes binding and legally enforceable—the date of marriage—and not at later dates when the installment payments are actually made, provided that the gift is susceptible to valuation at the time it becomes enforceable.[86] The facts in this ruling may be summarized as follows: (1) a premarital agreement is entered into prior to and in contemplation of marriage; (2) the agreement provides for future fixed annual payments by one spouse to the other spouse's trust; and (3) the annual payments begin one year after the date of the marriage and continue until the earlier of twenty years or the recipient spouse's death. In this ruling, the IRS noted that transfers in consideration of marriage or the release of marital rights are treated as gifts to the transferee from the transferor, and not bona fide sales or exchanges in exchange for full and adequate consideration.[87] The IRS determined that the gift was made at the time the agreement became effective—the date of marriage—and not when the agreement was entered into (prior to marriage), or when the property transfers were later made (on separate distinct dates after marriage).

Revenue Ruling 69-347 may be relevant to the analysis of the gift tax treatment of the promissory note received by the selling spouse from the spousal grantor trust. Section 1041(b)(1) treats transfers between spouses as acquired by gift, and the date of the gift should be the date that the obligation to make the transfer becomes enforceable (e.g., the effective date of the closing of the sale transaction), and not when payments are later made as required by the terms of the note (e.g., the date that the transferor arguably has parted with dominion and control of the transferred property).[88]

Because of Section 1041(b)(1)'s treatment of the selling spouse's receipt of the installment obligation as a gift from the grantor spouse, the transfer from the grantor spouse should be regarded as made at the time that the sale is complete and binding upon the grantor trust and the

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86 *See also* Rev. Rul. 84-25, 1984-1 C.B. 191 (gratuitous transfer of legally binding promissory note is a completed gift at the time it is binding and enforceable under state law and of a determinable value); Rev. Rul. 81-110, 1981-1 C.B. 479 (charitable gift is made on date that pledge becomes binding under local law); Rev. Rul. 80-186, 1980-2 C.B. 280 (transfer of an option to purchase real property to a related party for nominal consideration is a completed gift on the date the option is transferred if it is binding and enforceable under state law).

87 *See also* Treas. Reg. § 25.2512-8.

88 *See also* Estate of Copley v. Comm'r, 15 T.C. 17, 19-20 (1950), *aff'd* 194 F.2d 364 (7th Cir. 1952), *acq.* C.B. 1965-2, 4 (holding that once a premarital agreement becomes binding by marriage, the transferor spouse becomes bound to make all payments required by the agreement and does not make new gifts to the transferee spouse each time that payments are made); *See Harris*, 178 F.2d at 865 (holding that annuity payments to former spouse treated as taxable gift made at the time of a binding divorce decree for gift tax purposes).

selling spouse. Later transfers of property from the spousal grantor trust to the selling spouse, even after the grantor spouse's death, should not be viewed as "new" transfers to the selling spouse each time that they are made. In accordance with Revenue Ruling 69-347, the gift of the installment obligation under Section 1041, and thus its transfer for income tax purposes, should be viewed as complete at the time of the sale, and not the time that installment payments are subsequently made in accordance with the terms of the obligation.

(b) *Income Tax Treatment—Closed Transaction*

If the timing of the transfer of the installment obligation is analyzed under the income tax rules, the result should be the same—the transfer of the obligation should occur at the time that the sale of property is made and the obligation becomes binding, and not at subsequent dates when installment payments are made.[89] Because the sale is treated as a gift for income tax purposes, and not as a recognized sale subject to reporting under Section 453's installment method, the timing of the sale could be governed by the gift tax treatment discussed above. Nonetheless, it is helpful to look at the income tax treatment of transactions not reported under Section 453 to determine when this transaction may otherwise be deemed complete for income tax purposes.[90]

Prior to the enactment of Section 453 in 1980, there was extensive litigation to determine whether a transaction was "open" or "closed." An open transaction allowed for reductions in basis, and the gain on a sale of property in exchange for an installment obligation could be reported when payments were received. A closed transaction required the seller to recognize gain on the receipt of the installment obligation in the year of sale, and not later as installment payments were made. In general, a sale of property in exchange for an installment obligation of a fixed amount and pursuant to a fixed schedule was treated as a closed transaction that passes the benefits and burdens of the property to the purchaser.[91]

Even though the regulations apply to transactions where the taxpayer has elected out of installment reporting under Section 453 (which does not apply to sales of property between spouses), it may be appropriate to look to the regulations for guidance on whether a transaction is

89 *See*, *e.g.*, Fletcher v. United States, 303 F. Supp. 583, 583, 590 (N.D. Ind. 1969).

90 In addition, because the binding nature of the sale is determined under local law, the facts and circumstances of the sale are relevant to the timing of the deemed "gift" under § 1041(b)(1).

91 *See* Olson v. Comm'r, T.C. Memo. 1991-325, 62 T.C.M. (CCH) 146, 147 (1991).

open or closed for income tax purposes.[92] The regulations heavily favor regarding transactions as closed, and deny open treatment for any sales involving fixed payment obligations. A taxpayer electing out of installment treatment under Section 453(d) must report in the year of sale the fair market value of a fixed amount obligation under the cash method of accounting, and the total amount payable under a fixed amount obligation under the accrual method of accounting.[93] If the amount payable under an installment obligation is fixed, then under no circumstances will the installment sale be considered an open transaction.[94] If payments under the installment obligation are contingent and not fixed, a cash or accrual method taxpayer's amount realized in the year of sale includes at least the fair market value of the obligation, which must be at least the value of the property sold.[95] An installment sale for a contingent payment obligation will be considered open "[o]nly in those rare and extraordinary cases" where the fair market value of the contingent payment obligation cannot be reasonably ascertained.[96]

Although an analysis of the facts and circumstances surrounding the sale would determine whether the sale is an open or closed transaction for income tax purposes, it is generally well-established that a sale of property in exchange for a fixed and stated consideration that passes the benefits and burdens of the property to the purchaser will constitute a closed transaction reportable in the year of sale for income tax purposes.[97] A closed transaction for income tax purpose results when the contract of sale is absolute and unconditional and the seller must trans-

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92 *See*, *e.g.*, Coohey v. United States, No. C95-163, 1996 WL 773326, at *3, n.3 (N.D. Iowa Oct. 21, 1996) (noting that it was appropriate to look to tax treatment of transactions electing out of the installment method for purposes of transactions that are not reportable on the installment method, such as calculation of the AMT), *vacated on other grounds*, 98-2 USTC 50565 (8th Cir. Aug. 27, 1997).

93 Treas. Reg. § 15a.453-1(d)(2)(ii)(A).

94 *Id.*

95 Treas. Reg. § 15a.453-1(d)(2)(iii).

96 *Id.*

97 *See, e.g.*, Estate of Juden v. Comm'r, 865 F.2d 960, 961-62 (8th Cir. 1989) (holding that a taxable sale occurred upon sale of real estate from parents to children in exchange for assumption of mortgage on property); Estate of Brandes v. Comm'r, 87 T.C. 592, 597 (1986) (finding completed sale for tax purposes where contract for sale was executed, deed was executed, downpayment was made, and possession of property was delivered to purchaser); Ennis v. Comm'r, 17 T.C. 465, 469-70 (1951) (completed sale occurred upon sale of business in exchange for downpayment and deferred payment obligation, although non-negotiable deferred payment obligation was not the equivalent of cash included in cash method seller's amount realized in year of sale); Rev. Rul. 69-93, 1969-1 C.B. 139 (ruling that sale occurs at time that benefits and burdens of ownership pass to the buyer, and not at the time that a contract to sell property in the future is executed). *See also* Anschutz v. Comm'r, 664 F.3d 313, 324-25 (10th Cir. 2011) (listing factors for whether or when a sale has been completed).

fer the property to the purchaser upon payment of the consideration stated to secure the purchaser's immediate possession and exercise of all rights of ownership over the property.[98] As a result, an installment sale to a spousal grantor trust involving a fixed payment installment obligation should be regarded as a closed transaction in the year of sale for income tax purposes under both case law and the regulations.

2. *Application of Section 1041 to Payments Received by Selling Spouse after Grantor Spouse's Death*

If it is determined that the sale, and deemed gift, is complete on the date of the sale for purposes of Section 1041, then any installment payments the selling spouse receives in accordance with the terms of the note should continue to be governed by that section, even if the grantor spouse dies while the note is outstanding. If, in accordance with Section 1041, the selling spouse is treated as receiving the promissory note as a completed gift from the grantor spouse on the date of the sale, then all subsequent payments that the selling spouse receives on the note from the spousal grantor trust (or its successor) should be tax-free so long as the note is fulfilled according to its original terms. If the selling spouse receives all payments as originally promised on the date of the sale, then for income tax purposes the transaction should not be re-characterized as one between non-spouses solely as the result of the grantor spouse's death prior to receipt of all required payments. If the grantor spouse's successor is required to continue the payments, then the selling spouse should continue to receive the same income tax treatment that would have applied had the grantor spouse continued to make the payments. The selling spouse has taken no action to change the transaction, and thus should continue to receive the same treatment for income tax purposes as originally required by Section 1041's characterization of the transaction as a nontaxable gift between spouses.

Whether it also is possible for the selling spouse to continue to receive carryover basis treatment for non-cash payments made by the grantor spouse's successor pursuant to Section 1041 has not been addressed or definitively resolved. To avoid potential income tax issues, the better procedure may be for the spousal grantor trust to continue payments to the selling spouse in accordance with the terms of the note, and in cash. If installment payments are made in cash, this may help avoid any argument that the trust and the selling spouse made a taxable modification to the note if it required cash payments, or that the trust should recognize gain in the event that appreciated property is used to satisfy the note payments to the selling spouse. So long as the selling

[98] Comm'r v. Union Pac. R. Co., 86 F.2d 637, 639 (2d Cir. 1936).

spouse receives cash payments as required by the terms of the note, however, installment payments received by the selling spouse after the grantor spouse's death should continue to be tax-free under Section 1041. As discussed above, the completion of the deemed gift of the note from the grantor spouse to the selling spouse should occur at the time of the sale, and thus any installment payments made in accordance with the terms of the sale similarly should be governed by the rules of Section 1041.

3. *Selling Spouse's Basis in the Note*

The death of the grantor spouse, which causes the spousal grantor trust to be treated as a separate entity for income tax purposes, raises an additional question—what is the selling spouse's basis in the note received from the spousal grantor trust under Section 1041? Historically, the IRS has taken the position that basis in a self-made note should be zero, and the maker of the note only receives basis as principal payments are made. The IRS appears to be stepping-back from its zero basis position,[99] but it has made no pronouncements or otherwise taken a position on a promissory note's basis in the spousal grantor trust sale context.[100]

Section 1012 provides that an individual's basis in property is its cost, and cost includes the value of any cash or other property given to obtain the property.[101] If a promissory note is given in exchange for a sale of property, the purchaser's cost basis will include the value of the note. The question becomes whether the selling spouse's carry-over basis determined under Section 1041(b)(2) will be the face amount of the note, or whether the basis should be zero until principal payments are actually made from the trust.

If both spouses survive beyond the date that the note is paid in full, the zero basis approach should not have any income tax effect on the sale. Even assuming that the selling spouse receives a zero basis for the note under Section 1041, then, as discussed above, the selling spouse should receive a carry-over basis for any payments received in cash (or other property) treated as made by the grantor spouse pursuant to that section.

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[99] *See* Rev. Rul. 2006-2, C.B. 261 (revoking Rev. Rul. 74-503 and providing that zero-basis position for treasury stock issued in exchange for newly-issued stock in another corporation is under study).

[100] In Rev. Rul. 85-13, the IRS did note that the grantor did not receive a "cost" basis in property purchased from a wholly-owned grantor trust in exchange for a promissory note, but it did not resolve whether the "cost" basis in the note was transferred to the grantor trust. 1985-1 C.B. 184.

[101] Treas. Reg. § 1.1012-1(a).

If, however, the grantor spouse dies while the promissory note is still outstanding, the selling spouse's basis in the note may become relevant to determine whether gain or income is recognized on receipt of payments received after the grantor spouse's death.

As an initial matter, permitting the selling spouse, in effect, to receive a cost basis in the note as principal payments are made, even if made after the grantor spouse's death, would further the purposes of Section 1041. As discussed above, Section 1041's nonrecognition and transferred basis provisions were intended to defer recognition of gain or loss on any property transferred between spouses, not reduce or eliminate it. Also, as discussed above, the sale of property in exchange for the installment obligation should be a completed transaction between separate taxpayers governed by Section 1041 at the time of the sale. If, however, subsequent installment payments are made in property other than cash, there is a new transfer for purposes of Section 1041: the grantor spouse is treated as making a principal payment on the note and is credited with a reduction in principal owed equal to the fair market value of the property transferred as payment, and the selling spouse receives a transferred basis in the property pursuant to Section 1041(b)(2).[102] If the obligor of the note other than the grantor spouse, such as the spousal grantor trust which has now become a non-grantor trust as a result of the death of the grantor spouse, makes a payment in satisfaction of the note, the selling spouse's cost basis in the note should be considered to have increased by at least the fair market value of the property transferred, even if the selling spouse is assumed to have a zero basis until payments are made. Payments made in accordance with the note should continue to be treated as payments made as part of the grantor spouse's original gift to the selling spouse under Section 1041, and the selling spouse should be treated no differently than if he had received the payments directly from the grantor spouse had the grantor spouse lived. Since the selling spouse will receive the property tax-free, it could be viewed as a basis increase in the note immediately before the payment, and then a reduction in basis by the amount of the payment received.

The analysis does change, however, with respect to the basis of the property received in exchange. After the grantor spouse's death, Sec-

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[102] Indeed, this appears to support the policy behind taxing discharge of indebtedness income pursuant to § 61(a)(12): If an obligor is relieved of an otherwise binding obligation to pay issued in exchange for money or other property, for income tax purposes the obligor should be treated as receiving consideration equal to the amount of the discharged debt from the obligee, and in turn repaying it to the obligee in satisfaction of the debt. *See also* United States v. Kirby Lumber Co., 284 U.S. 1 (1931) (taxing difference between issue price for bonds issued by the taxpayer and repurchased at a discount on the open market as the realization of "an accession to income").

tion 1041 should no longer apply to any "new" transfers between the successor obligor on the note and the selling spouse. As a result, the selling spouse should have a cost basis in any payment received on the note up to its face value, and should not receive a new transferred basis under Section 1041. This treatment would again further the nonrecognition provisions of Section 1041 by preserving the original income tax attributes of the installment sale between the spouses, but eliminating the deferral of gain on payments that are not made between spouses: the selling spouse would take a cost basis in the note in accordance with the original terms of the sale, and the successor obligor would recognize gain with respect to any appreciated property paid in satisfaction of the note.[103]

Nonetheless, in determining the grantor spouse's basis in the note at the time of the sale, other commentators have examined developments in areas involving self-made notes in other contexts that look to the economic costs to the obligor in making the note.[104] In the partnership context, the IRS has held that a partner's contribution of the partner's own promissory note to a partnership has a zero basis, and the partner's basis is not increased until payments are made on the note.[105] In other contexts, courts have concluded that self-made promissory notes given by shareholders in exchange for S corporation stock do not increase the shareholders' basis in the stock where there is no economic substance to the transaction.[106] In the corporate context, the IRS has ruled that a shareholder has a zero basis in the shareholder's promissory notes contributed to his wholly-owned corporation where the taxpayer incurred no cost in making the notes,[107] although at least one court has concluded that a shareholder's basis in his unsecured promissory note transferred to a corporation is equal to face value, and not zero as claimed by the IRS.[108]

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103 *See*, *e.g.*, United States. v. Davis, 370 U.S. 65, 72-73 (1962) (husband's amount realized on transfer of appreciated property to wife was property's fair market value, and wife received basis in the property equal to its fair market value); Rev. Rul. 86-117, 1986-2 C.B. 157 (ruling that estate realized gain to the extent of the difference between the fair market value and the estate's basis in appreciated property transferred in satisfaction of tax liability); Treas. Reg. § 1.1001-2(c), Ex. 8 (debtor's amount realized on transfer of asset to creditor is its fair market value).

104 *See*, *e.g.*, Dana, *supra* note 1, at 348; ZEYDEL, *supra* note 1, ¶ B.1, at 15.

105 *See*, *e.g.*, Rev. Rul. 80-235, 1980-2 C.B. 229; I.R.S. CCA 201326014. A court has also denied summary judgment to a taxpayer seeking an increase in basis for capital expenditures made to condominiums with promissory note proceeds on the basis that a cash method taxpayer cannot deduct expenses until actually paid, which would not occur until the note is paid. Owen v. United States, 34 F. Supp. 2d 1071, 1080 (W.D. Tenn. 1998).

106 Silverstein v. United States, 349 F. Supp. 527, 530-32 (E.D. La. 1972).

107 Rev. Rul. 68-629, 1968-2 C.B. 154.

108 Peracchi v. Comm'r, 143 F.3d 487, 496 (9th Cir. 1998).

It should, however, be noted that the question regarding basis in a self-made note generally arises in situations where the note is given in exchange for an equity interest in a company, and the equity owner's basis in property contributed to the company affects the owner's basis on a subsequent sale of the equity interests. However, an installment sale to a spousal grantor trust does not involve a self-made note in this ordinary sense of the concept, as it is a note given as consideration for an exchange of valuable property between two separate taxpayers that does not include the purchase of a beneficial interest in the trust. Further, the person making the installment payments—the spousal grantor trust—is not relying on its basis in the note to support its basis in the property it received in exchange, and in fact could not receive a basis increase as payments are made on the note because its transferred basis in the property is governed by Section 1041.[109] As such, the facts of a spousal grantor trust sale are distinguishable from those involving a taxpayer's contribution of a self-made note to an entity in exchange for an equitable ownership interest and corresponding basis increase.

Because a sale to a spousal grantor trust involves a sale of property in exchange for a note, and not a mere promise to pay issued for no consideration or in exchange for a beneficial interest in the trust, an actual exchange of property on commercially reasonable terms should provide the selling spouse with a cost basis in the note. Based on an examination of relevant case law, it appears that the basis in a promissory note for the note's maker, its initial obligor, will depend on the economic realities of the transaction and the enforceability (or likelihood of enforceability) of the note against the obligor. Considerations for the economic substance of the transaction, or the actual economic outlay or costs incurred by the obligor in issuing the note, may include the following:

1) Business reasons or requirements for issuance of the note;[110]
2) Economic impairment to the obligor upon issuing the note;[111]
3) Risk of economic loss upon enforcement of the note;[112]

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[109] *See*, *e.g.*, PLR 8645082 (Aug. 14, 1986) (ruling that § 1274 does not apply to promissory note given by husband to wife in exchange for non-publicly traded property pursuant to marital settlement agreement, and thus the issue price is the stated redemption price at maturity, and that husband's transferred basis in property received from wife will not increase as payments are made on the note).

[110] *Silverstein*, 349 F. Supp. at 532.

[111] Perry v. Comm'r, 54 T.C. 1293, 1296 (1970).

[112] *See Peracchi*, 143 F.3d at 493.

4) Creditworthiness or solvency of the obligor;[113]
5) Availability of funds to pay the note;[114]
6) Value of security pledged for the note;[115]
7) Promissory note or evidence of indebtedness;[116]
8) Whether the note bears a fixed term;[117]
9) Whether the note bears a market rate of interest;[118]
10) Enforceability of the note;[119]
11) Reasonableness of expectation of repayment;[120]
12) Recordkeeping or documentation of the loan by the obligor and obligee;[121]
13) Subordination of the note to other debt of the obligor;[122]
14) Whether interest or principal payments have been made on the note;[123]
15) Enforcement of required payments on the note;[124] and
16) Reporting of the transaction as a sale of property in exchange for a loan for federal income tax purposes.[125]

It is possible that, given the relationship between the selling spouse and the spousal grantor trust, the IRS would argue that the sale is not a bona fide transaction with economic substance. To support the economic substance of a transaction entered into between two parties, courts may look to various factors:[126]

1) Whether the selling spouse controls the spousal grantor trust;
2) The trustee's recognition of fiduciary duties owed to the spousal grantor trust;
3) Whether the sale results in a change in the flow of benefits between the seller and purchaser; or

113 *Id.* at 493-94; Mayhew v. Comm'r, T.C. Memo. 1994-310, 68 T.C.M. (CCH) 25 (1994).
114 *See* Peracchi v. Comm'r, 143 F.3d 487, 495 (9th Cir. 1998).
115 Miller v. Comm'r, T.C. Memo. 1996-3, 71 T.C.M. (CCH) 1674 (1996); *Mayhew*, 68 T.C.M. (CCH) 25; *see also* Citizens Fidelity Bank & Tr. Co. v. Comm'r, T.C. Memo. 1956-162, 15 T.C.M. (CCH) 850 (1956).
116 *Miller*, 71 T.C.M. (CCH) 1674; *Mayhew*, 68 T.C.M. (CCH) 25.
117 *Peracchi*, 143 F.3d at 495.
118 *Id.*; *Miller*, 71 T.C.M. (CCH) 1674.
119 *Peracchi*, 143 F.3d at 495.
120 Fries v. Comm'r, T.C. Memo. 1997-93, 73 T.C.M. (CCH) 2085 (1997).
121 Miller v. Comm'r, T.C. Memo. 1996-3, 71 T.C.M. (CCH) 1674 (1996).
122 *See* Herrera v. Comm'r, T.C. Memo. 2012-308, 104 T.C.M. (CCH) 540 (2012).
123 Silverstein v. United States, 349 F. Supp. 527, 531 (E.D. La. 1972).
124 Mayhew v. Comm'r, T.C. Memo. 1994-310, 68 T.C.M. (CCH) 25 (1994).
125 *See Miller*, 71 T.C.M. (CCH) 1674.
126 *See* Widener v. Comm'r, 80 T.C. 304, 312-13 (1983) (upholding loss deductions on sale of loss property between two trusts with same income beneficiary and trustee).

4) The ultimate beneficiaries or successors to the exchanged property.

Revenue Ruling 85-13 itself may provide some support for the possibility of basis in a self-made note. In effect, Revenue Ruling 85-13 concluded that an exchange of property between a taxpayer and a grantor trust regarded as wholly owned by the taxpayer for income tax purposes results in a mere transfer of property, and its accompanying basis, from one pocket of the taxpayer to the other. In the grantor trust sale context, however, a fundamental issue with the ruling is that although it analyzes the grantor's transferred basis in appreciated property received from the grantor trust, it does not opine as to the grantor trust's basis in the promissory note received from the grantor.

Nonetheless, the answer to this question may be in the math of Revenue Ruling 85-13, which ultimately concluded that a gain of $30 was recognized when stock was sold by the taxpayer to a third party. In the ruling, the IRS stated that because the grantor's purchase of property, appreciated stock, from the grantor trust in exchange for a promissory note was not a sale for federal income tax purposes, the grantor did not receive a cost basis in the property acquired from the trust in exchange for an unsecured promissory note. If cost basis were allowed, it presumably would have been $40—the face amount of the note used to purchase the stock from the grantor trust. Under this scenario, the $30 of total inherent gain would be allocated as follows: (i) $10 of recognized gain to the grantor on the sale of stock to a third party for $50 with a $40 cost basis, and (ii) $20 of deferred gain in the grantor trust's note receivable from the grantor. However, in the ruling the IRS determined that when the grantor sold the stock to a third party for $50 the gain was $30 because the transfer of the stock from the grantor trust to the grantor was not a sale for income tax purposes, so the grantor took the trust's $20 transferred basis in the stock. All of the inherent $30 of gain was accelerated and recognized on the grantor's sale of the stock, and no gain was deferred at the trust's level. Since $30 of recognized gain on the sale of the stock to a third party is more than $10 (with $20 of deferred gain with the trust), the ruling demonstrates the apparent IRS position favoring increased current recognition of gain over deferral to later periods.

But what if the grantor had a zero basis in the note because it was self-made? If, rather than ruling that basis follows the property, the IRS determined that each party kept their basis and applied it to the property received in exchange, then the grantor would have had $50 of gain on the sale of the stock to the third party with a zero cost basis. In no way does the ruling appear to suggest that the grantor's cost basis in the stock would have been zero because the stock was purchased with a self-made promissory note. Indeed, the IRS makes several comments on ownership (and thus existence) of the promissory note, its use as the "purported consideration," and denial of cost basis to the grantor because there was no sale for income tax purposes, as the same person held the purported consideration both before and after the transaction. The discussion would have been much simpler if the IRS had indicated that the promissory note had a zero basis, or that the note itself did not exist for income tax purposes because it was a promise to pay to and from the same person.

Nonetheless, the law with respect to cost basis for installment promissory notes given as consideration for the sale or exchange of property should apply to a promissory note issued in a spousal grantor trust sale. The note and sale are not disregarded for income tax purposes because they are made by the same person, but rather are recharacterized as gifts exchanged between spouses. The note is not being given as a capital contribution in exchange for an equitable ownership interest: the spousal grantor trust is giving the note to the selling spouse in exchange for legal title to property. The promissory note should be recognized as property for federal income tax purposes, and the selling spouse should receive a cost basis equal to face value that the grantor spouse would have had in the absence of Section 1041. This question, however, has not been directly addressed by the IRS or the courts, and analysis of case law and other authority on the selling spouse's Section 1041 carry-over basis in a promissory note made by a purchasing grantor trust indicates that the answer may depend on the economic realities of the note issued to the selling spouse. As a result, care should be taken to document and adequately support the value and enforceability of the note and the sale, as well as the value of the property received in exchange or held as security for the note.

4. *Recourse v. Nonrecourse Nature of the Note*

Another concern that has been raised by various commentators relates to the potential for gain recognition with respect to a recourse or nonrecourse note on the death of the grantor spouse.[127] The concern looks to whether a change of obligor on the note from the grantor spouse to a non-grantor irrevocable trust as a result of the grantor spouse's death results in a taxable modification of the note for income tax purposes. In the case of a recourse note, unless an exception is met, a change in obligor results in a taxable modification.[128] A change in obligor on a non-recourse note, however, would not be a significant

127 *See* Dana, *supra* note 1, at 347; Zeydel, *supra* note 1, ¶ B.4 at 17-18.
128 Treas. Reg. § 1.1001-3(e)(4)(i)(A).

modification.[129] As a result, commentators generally have recommended structuring the note as nonrecourse debt with adequate security or guarantees to support the debt, to help avoid potential gain recognition on a change in obligor at the grantor spouse's death.[130]

Although the obligor may change from the grantor spouse to the trust at death, the better view may be that there is no taxable modification of the note so long as it remains binding on the trust and is paid according to its original terms. If the transaction were a completed transaction between spouses in the year of sale, the selling spouse should continue to receive payments on the note tax-free under Section 1041. In addition, the better position may be to structure the note as recourse to the spousal grantor trust to support the economic realities of the sale. Even if the note is recourse to the trust, it should not be regarded as recourse to the grantor spouse under state law: the trust, not the grantor spouse, is the obligor, only the trust's assets are available for satisfaction of the note, and none of the grantor spouse's assets would be reachable by creditors for payment. Thus, for income tax purposes, a note that is recourse to the spousal grantor trust should nonetheless be nonrecourse to the grantor spouse, even if the grantor spouse is regarded as owning all of the spousal grantor trust's assets for income tax purposes. The position of the commentators nevertheless is discussed below.

Under the regulations, a change of obligor on a nonrecourse note is generally viewed as an insignificant modification that will not cause an income taxable event, while a change of obligor on a recourse debt may cause a sale or exchange of materially different assets sufficient to cause gain recognition unless an exception applies, such as the new obligor acquiring all of the assets of the original obligor with the original terms of the loan otherwise remaining the same.[131] The recourse or nonrecourse nature of the debt generally will depend on whether, pursuant to state law, a creditor is limited to certain assets of the borrower, or whether the creditor can reach other personal assets of the borrower.[132]

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[129] Treas. Reg. § 1.1001-3(e)(4)(ii).

[130] *See* Dana, *supra* note 1, at 347; Zeydel, *supra* note 1, ¶ B.4 at 17-18.

[131] Treas. Reg. § 1.1001-3(e)(4)(i)(A), (ii).

[132] "Indebtedness is generally characterized as 'nonrecourse' if the creditor's remedies are limited to particular collateral for the debt and as 'recourse' if the creditor's remedies extend to all the debtor's assets." Simonsen v. Comm'r, 150 T.C. No. 8, 115-16 (2018) (quotation marks and citations omitted) (analyzing whether purchase-money loan secured by a deed of trust was nonrecourse debt under California's anti-deficiency statute); *see also*, Comm'r v. Tufts, 461 U.S. 300, 302 (1983) (noting that neither partnership nor partners assumed personal liability for a loan obtained by the partnership on a nonrecourse basis); Crane v. Comm'r, 331 U.S. 1, 13-14 (1947) (analyzing whether a seller's amount realized on the sale of encumbered property includes the principal balance of a

The recourse and nonrecourse nature of the debt, however, may also affect the factual analysis of the economic costs of the note and the likelihood of repayment, discussed above.

Although significant attention is paid to the rules governing the recourse and nonrecourse nature of an obligation and a change in the obligor, even if the debt is recourse to the trust, it would not appear that the debt should similarly be recourse to the grantor spouse. If the trust is the obligor and all of the trust's assets are available to satisfy the debt, then even though the grantor spouse is treated as the obligor for income tax purposes, only the assets of the trust the grantor spouse is deemed to own for income tax purposes are available to satisfy the debt. At the grantor spouse's death, the facts and circumstances should establish that the same assets were available to satisfy the debt, on the same terms and conditions, both before and after the grantor spouse's death. As a result, it appears that, under these facts and circumstances, a change in obligor on a promissory note of a spousal grantor trust as a result of the deemed owner's death should not be a significant modification causing gain recognition for income tax purposes.[133]

5. *Gain Recognition on Disposition of Installment Note*

Even assuming that the change in obligor upon the grantor spouse's death results in a constructive disposition for income tax purposes, the change should not result in any gain to the selling spouse. Section 453B provides that if an installment obligation is disposed of, gain or loss is recognized to the extent of the difference between the basis of the obligation and its fair market value at the time of disposition. For purposes of Section 453B, the basis of the obligation is defined as the excess of the obligation's fair market value over the amount of income that would be recognized had the obligation been satisfied in full, and any gain or loss is characterized by the sale or exchange of property for which the

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mortgage assumed by the purchaser where the seller was not personally liable on the debt).

[133] This should be viewed in contrast to the taxation of liabilities in excess of basis upon conversion of a grantor trust to a non-grantor trust during the grantor's lifetime set forth in Treas. Reg. § 1.1001-2(c), Ex. 5. If the personal debt of a grantor is transferred to or assumed by a trust, or if the grantor otherwise receives the economic benefit of the reduced basis (e.g., through income tax deductions taken with respect to trust property), there may be a good argument to tax the grantor's relief from this liability by transfer to a non-grantor trust. If, however, the liability was never a debt of the grantor's, but only treated that way for income tax purposes, the same analysis should not apply. The grantor trust would be the only entity receiving the benefits and burdens of the property (other than with respect to income taxes), and therefore the grantor should not per se be charged with any liabilities in excess of basis that do not otherwise benefit the grantor.

installment obligation was received.[134] Because the promissory note is viewed as a nontaxable gift to the selling spouse and the installment sale to the spousal grantor trust is ignored for income tax purposes, the note should not be treated as an installment obligation reportable on the installment method within the purview of Section 453B.

Even if the promissory note is viewed as an installment obligation for purposes of Section 453B, the selling spouse's basis in the note should be equal to its outstanding principal on the date of disposition.[135] Because the promissory note is viewed as a nontaxable gift from the grantor spouse for income tax purposes, the selling spouse would not have recognized any income and should have a basis equal to face value on the date of disposition.

6. *Recognition of Gain—Liabilities in Excess of Basis*

If the spousal grantor trust converts to a non-grantor trust at the grantor spouse's death or during life, there is a question as to whether the grantor spouse will be forced to recognize income for liabilities in excess of basis. Upon conversion of the grantor trust to a non-grantor trust, for income tax purposes the grantor is treated as transferring ownership of property previously treated as owned by the grantor under the grantor trust rules to the trust, now a separate taxpayer.[136] Upon this deemed transfer, the grantor may be forced to recognize gain to the extent of the liabilities in excess of basis associated with trust property.

With a traditional grantor trust sale, one question that has been considered is whether the IRS will treat the grantor as having transferred assets to the trust immediately before the grantor's death, and then require the grantor to recognize gain to the extent that liabilities assumed by the trust exceed basis in the assets transferred.[137] There is sparse authority in this area, other than in situations perceived as abusive that involve grantor trusts owning burnt-out tax shelters.

The three primary authorities—*Madorin v. Commissioner*,[138] Revenue Ruling 77-402, and Treasury Regulation Section 1.1001-2(c), Ex. 5—all involve the following facts:

(1) An individual (the "grantor") creates a grantor trust and is treated as the owner of the trust assets for income tax purposes under the grantor trust rules, Sections 671-677.

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134 I.R.C. § 453B(a), (b).

135 Section 453B(b) defines basis as the face value of the obligation over the income that would have been recognized if the obligation were satisfied in full.

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

137 *See* Blattmachr et al., *supra* note 84, at 149; Howard Zaritsky, *Tax Planning for Family Wealth Transfers During Life: Analysis with Forms* ¶ 12.07[3][c][ii] (2019).

138 Madorin v. Comm'r, 84 T.C. 667 (1985).

(2) The grantor trust purchases a partnership interest.

(3) The grantor deducts losses associated with the partnership interest, resulting in a corresponding reduction in the trust's basis in the partnership interest.

(4) Before the trust's basis in the partnership interest dips below zero or the time that the partnership starts generating income, the grantor renounces the grantor trust powers and the trust converts to a non-grantor trust.

(5) The grantor is treated as transferring the partnership interest to the trust at the time of the renunciation of the grantor trust powers, and must recognize gain to the extent that the trust's share of partnership liabilities exceed its basis in the partnership interest.

The economics of a deemed transfer between the grantor spouse and the spousal grantor trust differ from the transaction described above. In the partnership tax shelter transaction, the trust presumably included its share of partnership liabilities in basis, which allowed the grantor to take losses up to the point that the transaction turned around and the partnership would start to generate income. After conversion, increases in basis would be taxed as income to the trust, and not the grantor. In the spousal grantor trust sale, the grantor trust may be viewed as owning an asset with liabilities that exceed its basis. However, the liabilities were never initially included in the asset's income tax basis because Section 1041 required that the sale be treated as two separate transfers by gift between the spouses: (1) a transfer by gift of the property sold from one spouse to the other, with a carry-over basis; and (2) a transfer by gift of the installment note from one spouse to the other, with a carry-over basis. Indeed, the temporary regulations illustrate that, under Section 1041, a spouse's carry-over basis in property received from the other spouse does not include the benefit of any liabilities assumed by the transferee spouse, even if the liabilities are specifically associated with the property.[139] In addition, the grantor spouse never received or retained the economic benefit associated with the liability—here, the property sold to the trust—which has always been held as trust principal.[140] By reason of Section 1041, the spousal grantor trust never received the income tax or economic benefit associated with the liabilities encumbering the property "sold" to the trust, and has not taken any depreciation deductions requiring a decrease in basis initially

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139 Treas. Reg. § 1.1041-1T(d), Q&A 12.

140 TAM 200011005 (Nov. 23, 1999) (holding that where GRAT borrows funds from another trust to make annuity payments to grantor, grantor is treated as having disposed of assets to GRAT upon cessation of grantor trust status and the grantor's amount realized includes the GRAT's liabilities no longer treated as owned by the grantor).

enhanced by the liabilities.[141] Any assumption of the installment obligation issued in the spousal grantor trust sale would not relieve the grantor spouse of a liability associated with a previous tax benefit received by including the liability in basis. As a result, it would appear that the perceived abuse in the partnership tax shelter situation discussed above is not present with the spousal grantor trust sale, and thus the grantor spouse should not be treated as including liabilities in excess of basis for the property sold upon termination of grantor trust status.

Further, there appears to be no authority, regulatory or otherwise, indicating that liabilities in excess of basis in partnership interests or other assets owned by a grantor trust are recognized upon the death of the grantor.[142] In contrast, in the partnership tax shelter transaction discussed above, the grantor was able to dictate the time he would turn off grantor trust status and had the ability to renounce the grantor trust powers at any time he chose. By dying, a grantor has not been relieved of any liability previously benefiting the grantor by transferring the liability to another person. The termination of grantor trust status by death would appear to be outside the realm of such abuse.

Although the treatment of termination of grantor trust status by reason of death has never been definitively resolved for income tax purposes, it appears that the IRS would need to create a novel exception to the general rule of non-recognition for assumption of liabilities at death.[143] To avoid complexities associated with outstanding notes at the grantor's death, however, the general recommendation remains to pay the note off prior to the death of either spouse, to the extent reasonably possible.

If, however, grantor trust status terminates during the grantor spouse's lifetime, it would seem that the note payable to the selling spouse, if outstanding, should not be treated as a liability for purposes of determining the liabilities in excess of basis because Section 1041 should apply to any deemed transfer, although a full discussion of this issue is

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141 *See Madorin*, 84 T.C. at 677 (treating liabilities previously included in basis in amount realized accomplishes goal of recapturing tax benefits for decreases in basis). In *Madorin*, the IRS sought to include roughly $50,000 of partnership liabilities in excess of basis in the grantor's income, and the grantor had taken roughly $70,000 of deductions for losses associated with grantor trust property.

142 *See*, *e.g.*, Crane v. Comm'r, 331 U.S. 1, 6-7 (1947) (holding that devised realty with FMV equal to outstanding mortgage receives stepped-up basis equal to FMV of property, not value of decedent's equity at death).

143 Akers & Hayes, *supra* note 35, at 151 (discussing the IRS's observation that the rule including liabilities in excess of basis, to the extent the liabilities were previously included in a grantor trust's basis, are included in the grantor's amount realized upon conversion of a grantor trust to a nongrantor trust "is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the *death of the owner which is generally not treated as an income tax event*.") (quoting I.R.S. CCA 200923024).

beyond the scope of this article. With respect to termination of grantor trust status by or incident to divorce, any potential income from trust liabilities in excess of basis could be addressed in a divorce or separation agreement.[144]

V. Risk of Inclusion in Selling Spouse's Estate

As discussed in the introduction, one of the primary benefits of a sale to a spousal grantor trust is the potential for the selling spouse to have access to and control over the trust assets, which is *per se* prohibited in a traditional grantor trust sale. Specifically, the selling spouse could be a permissible beneficiary of the trust, possess a special testamentary power of appointment over the trust assets, or serve as a trustee of the trust. However, these additional benefits raise the potential risk of estate inclusion to the selling spouse. The terms and structure of the sale may help curb the risk that the selling spouse is treated as making a contribution to the trust for federal gift tax purposes, for example, by including a formula clause in the terms of the sale documents, by filing a gift tax return to start the running of the gift tax statute of limitations, or by giving the selling spouse interests or powers in the trust that cause any potential gift to be incomplete for gift tax purposes. As discussed below, however, the running of the gift tax statute of limitations may not prevent the IRS from claiming that the selling spouse transferred property to the trust for less than adequate and full consideration for estate tax purposes, and thus it is possible that the IRS may argue that a bargain sale to the trust results in inclusion in the selling spouse's gross estate under Sections 2036 or 2038.

A. Sections 2036 and 2038—Generally

If the sale is determined to be made for less than full and adequate consideration, the selling spouse may be viewed as a settlor with respect to the property sold to the trust to the extent it may be viewed as a

[144] It should be noted that if the parties become separated (but not divorced), the grantor spouse may continue to be taxed on any trust income received by the selling spouse. Prior to its repeal, § 682 provided that any trust income paid to a wife who is divorced or legally separated will be taxed to the wife if, in the absence of the statute, the trust income would otherwise be taxed to the husband. Act of Dec. 22, 2017, Pub. L. No. 115-97, § 11051(b)(1)(C), 131 Stat. 2054. If trust income is not paid to the selling spouse while still married, however, or if post-divorce the selling spouse retains powers that would cause the trust to be a grantor trust if held by the grantor spouse, the grantor spouse may continue to be taxed on the trust's income. The IRS has announced that it intends to issue regulations clarifying the effective date provisions of § 682's repeal, and requested comments on whether initial guidance on the application of grantor trust rules for trusts for the benefit of a spouse following divorce or separation. I.R.S. Notice 2018-37, 2018-18 I.R.B. 521.

taxable gift. In general, Section 2036 provides that the value of a decedent's gross estate "shall include the value of all property *to the extent of any interest therein* of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth)" and retained any interest in the property or right to designate the persons possessing or enjoying the property. Section 2038 generally provides that, except in the case of a bona fide sale for an adequate and full consideration in money or money's worth, property transferred to a trust is includable in the decedent's gross estate to the extent the decedent retained a power to alter, amend or revoke the transfer at the decedent's death. If a settlor transfers property to a trust for the settlor's benefit and creditors of the settlor can reach the assets of the self-settled trust under state law, the trust property may be includable in the settlor's gross estate under Sections 2036 and 2038.[145]

B. Ability of Selling Spouse's Creditors to Reach Trust Assets

The application of Section 2038 should, in part, depend on the ability of the selling spouse's creditors to reach trust assets under state law. Under general principles of trust law, assets transferred to a self-settled trust are not protected from the settlor's creditors.[146] State law may provide that the property of a revocable trust is subject to the claims of the settlor's creditors.[147] With respect to an irrevocable trust, the creditor of a settlor may reach the maximum amount that can be distributed to or for the settlor's benefit; provided, however, that if a trust has more than one settlor, the amount of trust assets that a creditor of a particular settlor may reach may not exceed the settlor's interest in the portion of the trust attributable to that settlor's contribution.[148] A settlor generally is defined as any person who creates or contributes property to a trust, and where more than one person contributes property to a trust, each person is a settlor of the portion of the trust's property attributable to that person's contribution.[149] As a result, under state law, the selling spouse's creditors should be limited to only that portion of the trust attributable to the selling spouse's contribution, if any, whether or not

145 Rev. Rul. 76-103, 1976-1 C.B. 293.

146 *See, e.g.*, Vanderbilt Credit Corp. v. Chase Manhattan Bank, 100 A.D.2d 544, 545-46 (N.Y. App. Div. 1984) (holding that a beneficiary who was also the settlor of the trust was not entitled to the trust's spendthrift protection whether or not the trust's creditors allege or prove a fraudulent transfer).

147 UNIF. TRUST CODE § 505(a)(1), (3) (UNIF. LAW COMM'N 2010).

148 UNIF. TRUST CODE § 505(a)(2).

149 UNIF. TRUST CODE § 103(15).

there is a segregation of assets to respective settlors under the terms of the sale documents or the trust instrument.[150]

If the IRS attempts to use Section 2038 as support to include the spousal grantor trust property in the selling spouse's gross estate on the basis that the selling spouse's creditors could reach the property transferred to the spousal grantor trust, the inclusion should similarly be limited to the portion of the spousal grantor trust property deemed to be contributed by the selling spouse under state law. If, however, the IRS proceeds with the theory that the selling spouse has made a transfer to the spousal grantor trust that was not a bona fide sale or was for less than full and adequate consideration, then as discussed below, the IRS potentially may argue that the entire value of the spousal grantor trust corpus, less the value of the consideration received at the time of the transfer, should be included in the selling spouse's gross estate.

C. Taxable Gift—Transfer for Less than Full and Adequate Consideration

1. *General*

If a transfer is made for less than an "adequate and full consideration in money or money's worth," then a deemed gift occurs to the extent that the value of the transferred property exceeds the value of the consideration received.[151] A taxable gift occurs upon a sale of property to the extent that the property transferred by the selling spouse exceeds the value "in money or money's worth" of the consideration given by the spousal grantor trust to purchase the property.[152] However, a sale of property made in the ordinary course of business—defined as a transaction that is bona fide, at arm's length, and free of any donative intent—is considered as made for an adequate and full consideration in money or money's worth.[153] Thus, if a transfer is made in the ordinary course of business, it will be presumed as made for adequate and full consideration for gift tax purposes.

It is unlikely that the IRS would view a sale of property from the selling spouse to a spousal grantor trust for the selling spouse's own benefit as made in the ordinary course of business, and thus deemed to be made for a full and adequate consideration.[154] As a result, the extent of

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[150] *See* RESTATEMENT (THIRD) OF TRUSTS § 60 cmt. f (AM. LAW INST. 2003).

[151] I.R.C. § 2512.

[152] Treas. Reg. § 25.2512-8.

[153] *Id.*

[154] Frazee v. Comm'r, 98 T.C. 554, 561 (1992). ("Transactions within a family group are subject to special scrutiny, and the presumption is that a transfer between family members is a gift.") (quoting Harwood v. Comm'r, 82 T.C. 239, 258 (1984), *aff'd* without published opinion 786 F.2d 1174 (9th Cir. 1986)).

a taxable gift on the sale will depend on the value of the property sold to the spousal grantor trust, which should be established by an independent third party appraisal. In addition, the selling spouse may decide to file a gift tax return to adequately report the transaction and start the running of the statute of limitations on a deemed taxable gift, discussed in more detail below.

2. *Terms of the Trust and Sale Documents; Use of a Formula Clause*

The terms of the spousal grantor trust sale documents could also protect against the possibility that the selling spouse is treated as having transferred property to the trust as a taxable gift, for example, by including a formula clause that provides for an alternative non-taxable disposition of property that is not sold to the trust for full and adequate consideration for gift or estate tax purposes.[155] There are many different types of formula clauses, each with certain advantages and disadvantages. Some formula clauses define the amount of property transferred regardless of its value, and allocate the transferred interest between the intended recipient and another non-taxable donee such as a spouse, charity, or incomplete gift trust. With this type of clause, the formula can be tied to an appraised value of the property so that if the value is adjusted as a result of a gift tax audit, any excess value is allocated to the non-taxable donee. Another type of formula clause defines the amount of property transferred by reference to a certain dollar amount (much like a typical formula clause that divides a residuary estate between the marital share and the credit shelter share). A formula clause that defined the amount of property transferred based on a certain dollar amount was approved by the Tax Court in *Wandry v. Commissioner*.[156] Although the IRS stated that it will not acquiesce to the Tax Court's decision in *Wandry*, it did not pursue the matter on appeal.[157]

In addition, to help simplify the administration of the trust and protect against the possibility of another transferor that would cause the trust to be treated as owned by a person other than the grantor spouse, the terms of the trust could require that, during the lifetime of the grantor spouse, the trustee is prohibited from accepting contributions from

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155 *See* Carlyn S. McCaffrey, *Formulaic Planning to Reduce Transfer Tax Risks*, 45 U. MIAMI HECKERLING INST. ON EST. PLAN. ¶ 701.6 (2011); Michael E. Morden, *"Reallocating" Wealth After* Christiansen*: A Fresh Look at Formula Clauses*, 35 ACTEC J. 97 (2009); Paige K. Ben-Yaacov, *Are Two Donees Better Than One?*, 29 A.B.A. PUB. REAL PROP. TR. & EST. L. SEC. 11 (2015).

156 Wandry v. Comm'r, T.C. Memo. 2012-88, 103 T.C.M. (CCH) 1472 (2012), *nonacq.* 2012-46 I.R.B. 543.

157 *Id.*

any person other than the grantor spouse. In the event that that a property transferred to the trust is determined to have been contributed by a person other than the grantor spouse, the trust could require a return of the property to the transferor (or the transferor's estate) with interest, or require that the property be held as a separate trust.

If the terms of the trust require the bifurcation of property received from a person other than the grantor spouse, then the trustee would be bound by fiduciary duties to follow the terms of the trust and adequately segregate any property to a separate trust. Similarly, if the transfer documents require that property constituting a taxable gift be transferred to a trust other than the spousal grantor trust involved in the sale, the terms of the sale documents should control.

D. Estate Tax Consequences—Transfers for Insufficient Consideration

The estate tax consequences of a sale that is neither bona fide, nor for an adequate and full consideration, may not be resolved by the running of the gift tax statute of limitations on the same transfer. Sections 2036 ("transfers with retained life estate") and 2038 ("revocable transfers") require inclusion of property that was transferred by a donor during lifetime, over which the donor retains certain powers or interests. Both sections contain an exception for a "bona fide sale for an adequate and full consideration in money or money's worth." This creates a two-part test to determine whether property sold to a spousal grantor trust may be subject to inclusion in the selling spouse's gross estate under Sections 2036 and 2038: (1) whether there was a bona fide sale—a question of motive; and (2) whether the sale was for adequate and full consideration in money or money's worth—a question of value.[158] It may be possible to plan around the estate tax inclusion risks of Sections 2036 and 2038 by appropriately structuring the spousal grantor trust and the sale documents.

1. *"Bona Fide Sale" Requirement*

The first test for determining whether a transfer is excluded from the decedent's gross estate under Sections 2036 or 2038 is whether the sale was "bona fide." In general, a bona fide sale will require a credible, non-tax purpose, and must alter the decedent's relationship with the transferred property.[159] The transaction also must be made in "good

[158] Estate of Bongard v. Comm'r, 124 T.C. 95 (2005); Estate of Hurford v. Comm'r, T.C. Memo. 2008-278, 96 T.C.M. (CCH) 422 (2008).

[159] *Bongard*, 124 T.C. at 114-15.

faith."[160] A bona fide transaction must be made at arm's-length, with some objective proof that ordinary parties to a business transaction would deal with each other in a similar manner.[161] Although it is possible to find that a transaction between parties was an arm's-length transaction, intra-family transactions are subject to heightened scrutiny because of the possibility of shifting tax burdens among parties without diminishing the transferor's ability to control or benefit from the transferred property.[162] A transaction may not be viewed as a bona fide sale where it is merely a sham or paper transaction, such as where

- properties allegedly transferred remain in the decedent's name;[163]
- the decedent remains financially dependent on the property transferred;[164]
- the decedent retains, in a personal capacity, the authority to control the transferred property or make distributions to himself upon request;[165]
- the decedent stands on both sides of the transaction;[166]
- the property transferred is used as the source of repayment for the property (rather than the purchaser's own funds or income from the property transferred);[167]
- legal formalities for the sale were not recognized, put in place, or followed;[168] or
- there was no intent to enforce an obligation that otherwise is, on its face, for fair market value, fully secured, and legally enforceable.[169]

Further considerations that may help support a bona fide sale include objective evidence of a negotiated sale:

- participation by an independent trustee or remainder beneficiaries;
- observation of corporate formalities in transferring interests or obtaining requisite consents;

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160 Treas. Reg. § 20.2043-1(a).
161 *Bongard*, 124 T.C. at 114.
162 *Id.* at 121.
163 Estate of Hillgren v. Comm'r, T.C. Memo. 2004-46, 87 T.C.M. (CCH) 1008 (2004).
164 *Id.*
165 Estate of Trombetta v. Comm'r, T.C. Memo. 2013-234, 106 T.C.M. (CCH) 416 (2013); Estate of Hurford v. Comm'r, T.C. Memo. 2008-278, 96 T.C.M. (CCH) 422 (2008).
166 *Bongard*, 124 T.C. at 116.
167 *Hurford*, 96 T.C.M. (CCH) at 422.
168 *Id.*
169 Estate of Maxwell v. Comm'r, 3 F.3d 591, 595 (1993).

- an analysis of the trust's ability to pay the installment note; and
- review of appraisals for the property sold.

2. *"Adequate and Full Consideration" Requirement*

As discussed above, the gift tax regulations presume that a transfer was made for full and adequate consideration if it was made in the ordinary course of business. The estate tax provisions, however, do not include a similar presumption for lifetime transfers subject to inclusion in a decedent's gross estate. As a result, it will be necessary to determine whether a transfer was for "adequate and full consideration," even if it is determined to be a "bona fide" sale. Furthermore, although the estate and gift tax provisions include the same language regarding "adequate and full consideration in money or money's worth,"[170] it has not been determined whether, and—as further discussed below—it may be unlikely that, the running of the statute of limitations on a deemed gift resulting from a transfer for insufficient consideration would estop the IRS from challenging the sufficiency of the consideration on the same transfer for estate tax purposes. In other words, any relief that a taxpayer (and the taxpayer's advisors) may feel when the statute of limitations expires for an audit of the gift tax return on which the sale to the spousal grantor trust was reported should be tempered by the fact that the IRS retains the ability to argue that the spousal grantor trust sale failed the "adequate and full consideration" test for estate tax purposes, resulting in potential estate inclusion even where the IRS is prevented from making the same argument for gift tax purposes.

The question of whether a transfer is made for an adequate and full consideration considers whether the transferor transferred something that was roughly equal in value to what was received,[171] or whether the price was an adequate and full equivalent reducible to a money value.[172] The primary question points to the purpose for inclusion of lifetime transfers in the gross estate: to determine whether the transferor's estate has been depleted by the transaction.[173] The determination of "adequate and full consideration" does not require a rigid exchange of exact, dollar-for-dollar value, but rather an exchange that is "approximately

170 *See* I.R.C. §§ 2036(a), 2038(a)(1), 2043(a), 2512(b), and accompanying regulations.

171 Estate of Bongard v. Comm'r, 124 T.C. 95, 113-21, 124 (2005).

172 Treas. Reg. § 20.2043-1(a).

173 Kimbell v. United States, 371 F.3d 257, 265 (5th Cir. 2004); Estate of Magnin v. Comm'r, 184 F.3d 1074, 1079 (9th Cir. 1999).

equal in value."[174] Adequate and full consideration, however, must be something more than "fair" consideration, the prior language used in the gift and estate tax statutes.[175] The exchanged value must be within a range of figures that could be deduced from available evidence regarding the property's value, although a 2-to-1 disparity between the value of the property transferred and the consideration received has been held to support a finding that the exchange was not of approximately equal value.[176] On review of whether a transfer was made for full and adequate consideration, a court may limit its review of the finder of fact's determination of value to the lowest, or most conservative, estimate of value reasonably supported by the evidence presented.[177] Thus, in a marital settlement case, a court used a midway estimated value between the $300 minimum acceptable amount chosen by the IRS and the ~$450 value estimated by the taxpayer's expert to determine that a husband's transfer to a revocable trust was substantially equal to the support rights the wife relinquished in exchange to qualify for the "adequate and full consideration" exception to Section 2036.[178] Because the value of the property transferred to the trust ($26,307.38) was substantially equal to the minimally acceptable estimate of value received in consideration ($26,385.15), there was no taxable gift.

3. *Section 2043(a) Reduction for Value of Consideration*

If property transferred other than pursuant to a bona fide sale for adequate and full consideration is included in the decedent's gross estate under Sections 2036 or 2038, then Section 2043 allows a reduction in the amount included for the consideration received on the transfer. The purpose of Section 2043 was meant to ameliorate inclusion of 100% of property transferred for insufficient consideration by removing the consideration received by the decedent from taxation, an attempt to provide some "measure of relief from double taxation of the same economic interest."[179] The reduction, however, is based on the value of

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[174] *Magnin*, 184 F.3d at 1081 (quoting Estate of Davis v. Comm'r, 440 F.2d 896, 900 (3d Cir. 1971)). *See also* Estate of Kitchin v. Comm'r, T.C. Memo. 1987-324, 53 T.C.M. (CCH) 1275 (1987) (holding that taxpayer's receipt of $49,895.20 in exchange for property approximately valued at $50,000 was for adequate and full consideration in money within the meaning of §§ 2036 and 2038).

[175] *See* Merrill v. Fahs, 324 U.S. 308, 311-12 (1945).

[176] Estate of Magnin v. Comm'r, T.C. Memo. 2001-31, 81 T.C.M. (CCH) 1126, 1143 (2001) (determination of "full and adequate consideration" on remand from *Magnin*, 184 F.3d 1074 (9th Cir. 1999)).

[177] Estate of Davis v. Comm'r, 440 F.2d 896, 900 (3d Cir. 1971).

[178] *Id.* at 899-900.

[179] Estate of Powell v. Comm'r, 148 T.C. 392, 406 (2017) (quoting Estate of Frothingham v. Comm'r, 60 T.C. 211, 216 (1973)).

the consideration received at the time of the transfer, and not the proportionate value of the trust property on the date of death.[180] As a result, if there is any appreciation in the property transferred to the trust from the date of the transfer until the date of death, all of the appreciation will be included in the selling spouse's taxable estate.[181]

Sections 2036, 2038, and 2043 arguably should not extend to property transferred by the grantor spouse, as the selling spouse did not make the transfer. The portion of the spousal grantor trust attributable to contributions from the grantor spouse, including any appreciation in transferred assets, should be excluded from the selling spouse's gross estate. Several cases have consistently excluded the portion of the trust attributable to another grantor, particularly in the community property area where contributions to the trust are divided between the surviving spouse and the decedent spouse.[182] One case in particular appears to apply a portion theory to a grantor's contribution to a trust, but in fact recognized that the situation involved two different grantors.

In *Estate of Glen v. Commissioner*, 45 T.C. 323 (1966), the Tax Court considered the includible portion of trusts in which the decedent spouse retained life estates within the meaning of Section 2036. In that case, pursuant to negotiations between a husband and wife around the time of their divorce, the husband transferred property to two trusts for the benefit of himself, his wife, and their descendants. The evidence established that the wife insisted on including provisions for their son, and that she wanted to allocate a portion of her personal rights in her husband's property to her descendants.[183] Upon divorce, under local law the wife would have at least had an enforceable claim to one-third of her husband's personal property, which she surrendered in consideration for establishment of the trusts.[184] The court determined that to the extent of at least the value of the wife's personal property rights, there

180 Estate of Magnin v. Comm'r, 184 F.3d 1074, 1082 (9th Cir. 1999).

181 *See id.*

182 Gradow v. United States, 897 F.2d 516, 518 (Fed. Cir. 1990) (affirming inclusion of portion of trust attributable to decedent's one-half interest in community property under § 2036, with reduction for value of consideration received under § 2043(a)); United States v. Past, 347 F.2d 7, 13-15 (9th Cir. 1965) (excluding decedent's portion of community property from inclusion in surviving spouse's gross estate); Estate of Christ v. Comm'r, 54 T.C. 493, 521 (1970), *aff'd* 480 F.2d 171 (9th Cir. 1973) (parties stipulated to division of trust funded with community property between portion attributable to surviving spouse's interest in property and portion attributable to decedent husband's interests on date of contribution); Estate of Gregory v. Comm'r, 39 T.C. 1012, 1019, 1022 (1963) (recognizing surviving spouse's portion of trust funded with community property as separate from the part of the trust consisting of decedent husband's portion of community property).

183 Estate of Glen v. Comm'r, 45 T.C. 323, 345 (1966).

184 *Id.* at 330.

was adequate consideration in money or money's worth for the transfers to the trust. The court allocated the value of the wife's personal property rights to the wife's income interest and the remainder interests to determine the portion of the transfers to the trust that were made for partial consideration, and thus were not includible in the husband's gross estate under Section 2036.[185] The remaining trust transfers were made without consideration in money or money's worth, and were subject to inclusion under Sections 2036 and 2043(a).[186]

Although the court divides the trusts into two portions—one that was transferred for adequate consideration, and thus not includible under Section 2036, and one that was not and was includible under Sections 2036 and 2043(a), the case may more properly be viewed as a division of the trust into portions attributable to contributions by the husband and those by the wife. The facts establish that the wife had an enforceable property right against her husband, and that she negotiated release of this right in consideration for his transfer to the trusts. The wife, here, was more properly viewed as the grantor of the portion of the trusts attributable to her transfer, and thus division of the trusts into portions attributable to the husband and portions that were not appears correct. Indeed, in a footnote the court even noted that, presumably, the transfers to other beneficiaries of the trusts at the wife's insistence would be treated as taxable gifts made by her, not the husband making the transfer.[187] So even though the court speaks in terms of partial consideration for purposes of determining the portion of the trusts subject to inclusion or not under Section 2036, this case more properly should be viewed as the court's determination of the identity of the grantors contributing property to the trusts.

In determining what portion of the spousal grantor trust is attributable to the grantor spouse's seed gift and the selling spouse's contribution, the IRS may take the position that the selling spouse's portion of the trust includes the entire value of the property sold to the trust, as determined for estate tax purposes, without reduction for any consideration given in exchange. A similar result was reached in *United States v. Past*,[188] where the court held that where decedent contributed one-half of community property to a trust in exchange for a life estate in the trust

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185 *Id.* at 323.

186 *Id.* at 347.

187 *Id.* at 344, n.13. *See also* Estate of Marshall v. Comm'r, 51 T.C. 696, 701 (1969) (holding that where husband transferred property to trust for wife in consideration of wife's relinquishment of debt claim against him, husband acted as wife's agent, and wife was settlor of trust to the extent of the value of her claim).

188 United States v. Past, 347 F.2d 7 (9th Cir. 1965). The methodology employed in *Past* was criticized by *Estate of D'Ambrosio v. Comm'r*, 101 F.3d 309, 313-14 (3d Cir. 1996).

property, one-half of the date of death value of the trust was included in her estate, reduced by the value of the consideration received by her at the time of the transfer. Even if the gross, rather than net, value of property sold to the trust is used to determine the selling spouse's portion, the portion of the trust (and its appreciation) attributable to the seed gift from the grantor spouse should not be protected from inclusion in the selling spouse's estate.[189]

If the gross value of the property sold to the spousal grantor trust is attributed to the selling spouse, Section 2043(a) should allow a reduction in the amount included under Section 2036 for the value of the consideration received at the time of the transfer. This interpretation would actually protect the value of the consideration received by the selling spouse from estate taxes. This curious result appears to occur where the consideration for the sale is in fact paid from the property the selling spouse transferred to the trust, rather than from a source that otherwise would not have been included in the selling spouse's estate.[190] In this situation, the fair market value at the selling spouse's death of the property sold to the trust should already account for the consideration paid to (and included in the estate of) the selling spouse. As a result, Section 2043's formula of subtracting the consideration received on the sale from the date of death value of the trust would exclude the consideration from estate taxation, rather than potentially subjecting it to double taxation.

For example, in our earlier analysis the grantor spouse contributed $700,000 to the spousal grantor trust, and the selling spouse transferred property worth $10 million, discounted to $6.5 million on the sale. If for purposes of Sections 2036 or 2038 the property is valued without any discount, and is determined to have been worth the full $10 million on the date of the sale, the portion of the trust attributable to the selling spouse's transfer to the trust, reduced by $6.5 million of consideration, would be included in the selling spouse's gross estate. The date of death value of the selling spouse's portion of the trust, however, would already factor in the $6.5 million of consideration paid to the selling spouse because it is a debt against the trust property. For example, ignoring the seed gift and any value attributable to the selling spouse's beneficial interest in the property, (1) if the promissory note is outstanding on the

[189] *See, e.g.*, Estate of McLendon v. Comm'r, T.C. Memo. 1993-459, 66 T.C.M. (CCH) 946, at 969, 973 (1993) (allowing § 2043 reduction in value for property included in gross estate for $250,000 down payment, but disallowing reduction for value of annuity found to be illusory), *rev'd on other grounds* 77 F.3d 477 (5th Cir. 1995).

[190] *See, e.g.*, Estate of De Foucaucourt v. Comm'r, 62 T.C. 485, 490-91 (1974) (value of property included in decedent's gross estate in which decedent retained a life estate and had sold to nephews for less than full and adequate consideration was reduced by annuity received from nephews).

date of the selling spouse's death and the property sold to the spousal grantor trust has increased in value to $20 million, the value of the spousal grantor trust is $13.5 million: $20 million of property sold to the trust, plus a $6.5 million liability, and (2) if the promissory note has been paid by the time of the selling spouse's death, the date of death value of the trust is also $13.5 million: $20 million of assets, reduced by the $6.5 million liability paid out to the selling spouse. Under Section 2043(a), "only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefore," is included in the decedent's gross estate. On these facts, $7 million of the trust property would be included in the selling spouse's gross estate: $13.5 million date of death value, reduced by $6.5 million in consideration received at the time of the sale. The total amount included in the selling spouse's gross estate is $13.5 million: $6.5 million of consideration owned at death, and $7 million of the trust property under Section 2036 and Section 2043(a). If the policy behind the statutes is to tax the amount of property that otherwise would have been included in the selling spouse's estate—the property sold to the trust with a date of death value of $20 million—then under this example it appears that $6.5 million has escaped taxation, which is the amount attributable to the consideration received from the trust at the time of the transfer.

Nevertheless, the IRS may argue that reduction of the trust's date of death value by the full amount of the consideration given pursuant to Section 2043 violates the purpose of the estate tax provisions and should not be allowed. Section 2036's purpose was to prevent avoidance of estate taxes by including transfers with retained life estates as testamentary transfers subject to gross estate inclusion.[191] If removing the consideration received from the trust on the spousal grantor trust sale is perceived as frustrating the intent for inclusion of trust property in the gross estate, then the IRS may argue that the purchase price received by the selling spouse from the trust should not be considered for purposes of Section 2043.[192]

191 Helvering v. Bullard, 303 U.S. 297, 302 (1938) ("It is true that an ingenious mind may devise other means of avoiding an inheritance tax, but the one commonly used is a transfer with reservation of a life estate.") (quoting *In re* Keeney's Estate, 87 N.E. 428, 429 (N.Y Ct. App. 1909), *aff'd* Keeney v. Comptroller, 222 U.S. 525 (1912)).

192 For example, in *United States. v. Allen*, 293 F.2d 916 (10th Cir. 1961), the Tenth Circuit considered whether a sale of the decedent's retained life estate in a trust was sufficient to remove the trust property from inclusion in her gross estate under § 2036. The decedent had created an irrevocable trust, retaining an interest in the trust income. She was later advised that the retained income interest would cause inclusion of the trust property in her gross estate at death, and so she sold her beneficial interest in the trust to her son for $140,000, when the actuarial value of the remainder of her income interest

This argument historically has been successful with respect to life estates retained in property transferred to a trust, which has been held to not be included in the concept of "consideration" by virtue of Section 2036. Because that section sought to include the date of death value of all property transferred by a decedent in which the decedent retained a life estate, courts have concluded that the value of the retained life estate cannot be consideration for the transfer for purposes of Section 2043,[193] and cannot be excluded from the value of the property transferred at the time of sale.[194] The retention of the life estate itself is the interest in the property causing inclusion under Section 2036, so removing it as consideration under Section 2043 would frustrate the purpose of taxing 100% of the date of death value of the property transferred.

More recent cases, however, have refused to apply the rule that the amount of consideration received for purposes of Section 2036 is measured against the full fair market value of the property sold, not the fair market value of the interest in the property sold, and have excluded the value of retained life estates or interests for purposes of determining whether the remainder interest was transferred for full and adequate consideration.[195] These cases note that no reasonable person would

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was approximately $135,000. The government argued that the full value of the trust corpus underlying the decedent's income interest should be included in the decedent's gross estate, less the $140,000 of consideration. The court determined that allowing the decedent to sell her income interest shortly before death to avoid inclusion of trust corpus that would have been included had she retained the income interest would not further the purposes of the statute. The court in *Allen* stated that it did not believe that "Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates," and that such a result "would allow the taxpayer to reap the benefits of property for his lifetime and, in contemplation of death, sell only the interest entitling him to income, thereby removing all of the property which he has enjoyed from his gross estate." *Id.* at 918. The court concluded that, despite the plain wording of the statute, the value of the trust corpus should be included in the decedent's gross estate to further what Congress intended.

193 *Past*, 347 F.2d at 13 (life estate retained by decedent on transfer of her portion of community property to trust not included as consideration for purposes of § 2043); Estate of Gregory v. Comm'r, 39 T.C. 1012, 1017 (1963) ("It is clear that retention of a life estate in one's own property cannot be consideration for a transfer [included under § 2036].").

194 *See, e.g.*, Estate of Glen v. Comm'r, 45 T.C. 323, 343 (1966) (holding that excluding value of life estate retained by donor from the value of the property donor transferred to the trust should be rejected because it is no different than arguing that the value of a retained life estate should be regarded as part of the consideration received for the transfer).

195 Estate of Magnin v. Comm'r, 184 F.3d 1074, 1077 (9th Cir. 1999) (court not bound to follow rule excluding life estate from consideration for purposes of § 2043 that was enunciated in *Past*, where the rule was assumed without discussion); Wheeler v. United States, 116 F.3d 749, 767 (5th Cir. 1997) (holding that sale of remainder interest in property for its actuarial value constituted an adequate and full consideration under § 2036); D'Ambrosio v. Comm'r, 101 F.3d 309, 314-15 (3d Cir. 1996) (holding that sale of remain-

purchase a remainder interest in property at the property fee simple price, and thus only the value of the remainder (or other interest in the property transferred) is relevant to whether there was an adequate and full consideration for estate tax purposes.[196] These more recent cases further may suggest that, in measuring the value of the consideration received for the stock for purposes of Sections 2036 or 2038, the value of the property sold to a spousal grantor trust may be reduced by the value of the selling spouse's beneficial interest in the portion of the trust consisting of the property sold, if it is sufficiently guaranteed to be regarded as consideration given in money or money's worth (e.g., an income interest for life that can be valued by actuarial tables).

But our example above ignores the retained interest in the property potentially causing inclusion under Section 2036—the selling spouse's beneficial interest in trust property. Rather, the stated consideration under the terms of the installment sale—the $6.5 million purchase price—is deducted by virtue of Section 2043(a). To exclude this amount from consideration, the IRS could try to argue that the downpayment and the promissory note received in the sale must be viewed as a retained interest causing inclusion of the property sold under Section 2036. Because of the differences between the "retained" beneficial interest in the trust and the consideration received on the sale, this argument may not be successful with a bona fide debt obligation based on the plain language of Sections 2036 and 2038.[197]

Another approach would be to deduct the value of the promissory note from the value of the property sold to the trust at the time of the sale, and treat only the deemed gift or transfer to the trust—$3.5 mil-

der interest for its fair market value, not fee simple value, constitutes adequate and full consideration within the meaning of § 2036).

196 *Magnin*, 184 F.3d at 1078 ("[N]o rational person would ever purchase a remainder interest for the price of the full fee-simple interest in the same property."); *Wheeler*, 116 F.3d at 759 (noting conundrum where sale of remainder interest at actuarial value results in estate inclusion under § 2036, but where decedent is "somehow able to find a willing purchaser of [the] remainder interest for the full fee-simple value of the underlying property," inclusion under § 2036 is avoided, but purchaser would have made a taxable gift); *D'Ambrosio*, 101 F.3d at 316 (noting that absent a buyer willing to speculate that the future value of an asset would skyrocket, few, if any, sales of remainder interests would ever take place if adequacy of the consideration is measured against the full fee simple value).

197 Under the principles of *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958), the promissory note potentially could be recharacterized as a retained interest for purposes of § 2036. For a discussion of *Fidelity-Philadelphia Trust* and potential treatment of a promissory note as a disguised § 2036 retained interest, see, e.g., Akers & Hayes, *supra* note 35, ¶XII.H at 152-54; Ronald D. Aucutt & Howard M. Zartisky, *Structuring Estate Freezes: Analysis with Forms*, ¶ 12.02[5][d] (2018); *See also*, Michael D. Mulligan, *Recent Cases Explore Tax Planning Strategy of Sale to an IDIT*, 43 EST. PLAN. 3 (2016).

lion—as having been transferred to the trust without consideration. If the grantor spouse gave $700,000 to the trust, treating the selling spouse as transferring $10 million would disproportionately deplete the value of the grantor spouse's portion by the debt carried on the property.[198] The logical conclusion is that, for purposes of Section 2036, the selling spouse only transferred property worth $3.5 million to the spousal grantor trust for no consideration within the meaning of Section 2043(a): $10 million of property, reduced by $6.5 million of debt. Under this scenario, the selling spouse's portion of the trust is 16.67% of the trust ($700,000/$4,200,000), as compared to 6.54% ($700,000/$10,700,000), and the selling spouse's portion of the trust is 83.33% ($3,500,000/ $4,200,000), rather than 93.46% ($10,000,000/$10,700,000). This approach also would more closely resemble the portion theory applied in *Glen*:[199] the selling spouse only transfers an interest in property worth $3.5 million to the trust for less than adequate consideration that is subject to Section 2036, because he received full consideration for an interest in property worth $6.5 million in the form of an obligation of the trust. The receipt of consideration for $6.5 million of property from the trust should negate any "transfer" of that property to the trust, as it was for full consideration. The portion of the trust representing $3.5 million of property—the selling spouse's portion of the trust—would be included for purposes of Section 2036, without reduction for consideration because none was given for this portion of the property sold to the trust. Assuming that, for purposes of simplification, the selling spouse dies immediately after the transaction, the result would achieve Section 2036's purpose of including the value of 100% of the transferred property that otherwise would have been included in the selling spouse's gross estate, or $10 million: $6.5 million in the form of the note held by the selling spouse, and property transferred to the trust with a value of $3.5 million.[200] This also is consistent with Sections 2036 and 2043(a)'s effect of including 100% of the appreciation on property transferred to the trust, as the entire portion of the trust attributable to the property sold—$3.5 million—would be included in the settlor's gross estate. The portion of the trust attributable to the seed gift of $700,000, and any appreciation, would not be subject to inclusion in the selling spouse's estate.[201]

[198] *See, e.g.*, *Glen*, 45 T.C. at 348. This depletion would be more than made up for, however, if § 2043(a) were applied to reduce the value of the selling spouse's portion by $6.5 million of consideration.

[199] *Id.* at 347.

[200] *Magnin*, 184 F.3d at 1079 (recognizing underlying purpose of § 2036 is to prevent depletion of the decedent's gross estate).

[201] This conclusion, again, requires that all of the trust's debt be allocated to the selling spouse's portion, even though the grantor spouse's portion would be liable on the

However, given the non-uniformity for identification or valuation of a transfer for purposes of Section 2036, amounts included as consideration, and application of Section 2043(a), it is difficult to predict how those sections would be applied to a grantor spousal trust sale.

E. Adequate Disclosure & Running of Statute of Limitations

1. *Gift Tax Return Statute of Limitations*

For gift tax purposes, the extent to which a sale to a spousal grantor trust is a gift should be finally resolved upon passing of the statute of limitations on a sale that is adequately disclosed as a non-gift completed transfer on a timely filed gift tax return,[202] or upon completion of an audit of the transaction. If a deemed taxable gift is determined to have been made on audit, the terms of the sale documents or trust agreement could ameliorate any related gift or estate tax consequences associated with the deemed gift if formula clauses are used to determine the recipient of the property interests transferred. If the statute of limitations runs, and it is therefore established that the selling spouse did not make a taxable gift—whether complete or incomplete—on the sale to the spousal grantor trust, the IRS should be precluded from claiming interest or penalties if it later determines that the transaction should have resulted in a taxable gift and payment of gift tax to the extent the deemed gift exceeds the selling spouse's available unified credit.

2. *Estate Tax Return Statute of Limitations*

The gift tax regime is supplementary to the estate tax regime, and they must be read *in pari materia* and construed together.[203] As a result, the same phrases occurring in both contexts and concerning the same subject matter must be interpreted the same, unless obvious reasons compel divergent treatment.[204] It does not necessarily follow, however, that a final determination that a transfer was made for "adequate and full consideration" for gift tax purposes by running of the statute of limitations similarly requires a final determination of value for purposes of Sections 2036 or 2038 for estate tax purposes.[205] It is well-established that arguments regarding the statute of limitations are construed strongly against the taxpayer and in favor of the IRS.[206] Indeed, Section 2001(f) in large part was passed to help provide finality for taxpayers

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debt, as well. The $650,000 down payment also was paid out of the selling spouse's portion, which ordinarily would be viewed as consideration for purposes of § 2043(a).

202 Treas. Reg. § 301.6501(c)-1(f)(4).

203 *See* Merrill v. Fahs, 324 U.S. 308, 311 (1945).

204 *Id.* at 313.

205 *See* Bramwell, *supra* note 8, at 22-24.

206 Badaracco v. Comm'r, 464 U.S. 386, 391-92 (1984).

and prevent the IRS from revaluing taxable gifts for estate tax purposes that were otherwise barred from revaluation for gift tax purposes. It does not necessarily follow, however, that the same purposes would be applied to limit inquiry into whether a transfer was made for an adequate and full consideration for estate tax purposes, even if the statute of limitations prevents the same inquiry for gift tax purposes.

For example, if the gift tax return statute of limitations had passed on an adequately disclosed non-gift transaction, it appears that Section 2001(f) prevents the IRS from revaluing the transaction to determine whether a deemed gift occurred in accordance with Section 2512. A strict and limited application of Section 2001(f), however, does not appear to extend to a revaluation of the same transaction to determine whether it was made for a full and adequate consideration for estate tax purposes under Sections 2036 and 2038.

Although a final gift tax determination under Section 2001(f) applies to all adjustments relating to the gift, both as to valuation and legal issues involving interpretation of the gift tax law,[207] application of Sections 2036 and 2038 to lifetime transfers does not actually require that a taxable gift occur, despite using similar language. Indeed, although both the gift and estate tax regimes seek to tax certain transfers made for less than "a full and adequate consideration in money or money's worth," Sections 2036 and 2038 go further to also require that the transfer be a "bona fide sale."

The effect, however, appears to be much the same in both circumstances: if there is a deemed taxable gift on the initial sale, Section 2001 would not include the gift in adjusted taxable gifts, thereby eliminating double taxation of the same transfer. The full value of the transferred property, reduced by the consideration received at the time of the sale, would be included in the decedent's gross estate. On the other hand, if the initial determination of a taxable gift is barred by running of the statute of limitations, the IRS may nevertheless argue that the transfer is included under Sections 2036 or 2038 as having been made for less than an adequate and full consideration. Again, the full value of the transferred property, reduced by the consideration received at the time of the sale, would be included in the decedent's gross estate. Because the statute of limitations has run on the gift, however, the estate would not incur penalties or interest if the deemed gift would have exceeded the available unified credit and required payment of gift tax.

One important difference, however, is that the taxpayer may be able to plan for or ameliorate potential gift and estate tax consequences for a deemed taxable gift imposed on audit, whether by allowing the

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[207] Treas. Reg. § 20.2001-1.

terms of the trust or sale documents to account for the deemed gift and provide for different treatment, or by releasing any "retained" rights or powers over the gift portion prior to the taxpayer's death. If the adequacy of consideration remains open until the taxpayer's death, however, amelioration of the estate tax consequences is more difficult. Although it has not been determined, this situation may allow for an estoppel defense for estate tax purposes where the IRS determines an "adequate and full consideration" on audit for gift tax purposes, but estoppel may be unavailable where the sufficiency of the consideration is fixed not on audit by the IRS, but by the mere running of the statute of limitations.[208]

If the IRS actually challenges the amount of the gift on audit for gift tax purposes, it appears that the same conclusion as to "adequate and full consideration" should apply for estate tax purposes, as the exact same language is used in both contexts. Further, the taxpayer may be able to satisfy the traditional requirement for estoppel, as the audit could be construed as an affirmative representation by the IRS as to the adequacy of the consideration on the transfer. In this situation, the taxpayer's estate may be able to establish an affirmative representation by the IRS that was relied upon to the detriment of the taxpayer regarding the adequacy of the consideration received on the sale.

3. *Planning to Minimize the Risk of Estate Inclusion, and Extent of Retained Interests or Powers*

As discussed above, Sections 2036 and 2038 provide a basis for the IRS to include the spousal grantor trust property in the selling spouse's estate if the selling spouse makes a transfer for less than full and adequate consideration and retained the possession, enjoyment, or right to the income from the property (Section 2036(a)(1)); the right to designate the persons who shall possess or enjoy the property or the income therefrom (Section 2036(a)(2)); or where the enjoyment of the transferred property was subject to any change through the exercise of a power to alter, amend, revoke, or terminate (Section 2038(a)). Although Sections 2036 and 2038 are estate tax inquiries, a number of possible scenarios exist where the risk of estate tax inclusion can be greatly reduced or eliminated.

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208 *See* Shafmaster v. United States, 707 F.3d 130, 136 (1st Cir. 2013) (holding that when a party seeks to equitably estop the government, it "must show that the government engaged in affirmative misconduct").

(a) *Sale to Spousal Grantor Trust in a Domestic Asset Protection Trust Jurisdiction*

If the selling spouse is a resident of a state that has a self-settled asset protection trust statute, and the selling spouse is willing to forego the ability to be a trustee of, and have a special testamentary power of appointment over, the spousal grantor trust, then the risk of inclusion in the selling spouse's estate as a result of a sale for less than full and adequate consideration can be greatly reduced. The basis for estate inclusion under Section 2036(a)(1) in a non-domestic asset protection trust state is that if the selling spouse's creditors can attach the trust assets because the selling spouse is a beneficiary of the trust, then the transfer to the trust is considered to be incomplete and thus includible in the selling spouse's estate.[209] Over two dozen states now have domestic asset protection trust statutes, and the IRS has ruled that a taxpayer who is a resident of such a state and who properly follows the domestic asset protection statute in the creation, funding, and administration of such a trust, can be a discretionary beneficiary of such a trust without causing estate inclusion under Section 2036(a)(1).[210] Therefore, in a domestic asset protection trust state, a selling spouse who is determined at death to have sold property to the spousal grantor trust for less than full and adequate consideration arguably should nevertheless avoid the application of Sections 2036(a)(2) and 2038(a) if the spousal grantor trust does not grant the selling spouse a power of appointment over the trust, and does not make the selling spouse a trustee of the trust, avoids all other Sections 2036 and 2038 strings, and the trust otherwise complies with the applicable self-settled trust statute.[211]

(b) *Sale to Spousal Grantor Trust of Assets Having Little Undervaluation Risk*

The risk of estate inclusion under Sections 2036 and 2038 is premised on the IRS successfully arguing that the sale of assets to the spousal grantor trust was made for less than full and adequate consideration. In many planning scenarios that involve a traditional grantor trust sale or a spousal grantor trust sale, part of the planning involves utilizing valuation discounts. Typically, the selling spouse sells a minority interest (perhaps even a non-voting interest) in a closely held entity to the spousal grantor trust. A third-party appraisal documents the value of the interest sold, including valuation discounts for lack of mar-

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209 *See* Rev. Rul. 76-103, 1976-1 C.B. 293.

210 *See, e.g.,* PLR 200944002 (Jul. 15, 2009).

211 Steve R. Akers, *Selected Highlights of 2017 Tax Act and Estate Planning Considerations*, BESSEMER TRUST, https://www.bessemertrust.com/sites/default/files/2018-06/Legislation_2017_Selected_Highlights_Tax_Cuts_WEBSITE_FINAL.pdf, at 37 (2018).

ketability and lack of control, and these combined valuation discounts can sometimes exceed forty percent (40%) when compared to the proportionate share of the underlying enterprise value of the closely-held entity. However, studies have shown that the estate tax benefits of engaging in grantor trust sale planning are not limited to the level of the valuation discount experienced at the time of the sale, but also include the growth of the assets transferred outside of the selling spouse's estate for the remainder of the selling spouse's lifetime, as well as the tax-burn associated with the grantor spouse paying the income tax out of personal assets.[212]

Recognizing this fact, a taxpayer could structure a spousal grantor trust sale so that no valuation discounts are applicable (such as the sale of ownership interests that possess liquidation rights). Similarly, if there are truly independent third-party transactions in the equity of the closely-held entity in close proximity to the date of the spousal grantor trust sale, the price at which the equity changed hands in a third-party sale could establish the "full and adequate consideration" requirement in a manner that a third-party appraisal may not. Since estate inclusion under Sections 2036 and 2038 is based on getting the valuation wrong on the date of the sale, any method of minimizing this valuation risk decreases the risk of estate inclusion. Even with the sale of an interest in a closely-held entity, obtaining a high quality, independent appraisal can greatly minimize the estate inclusion risk. If the value of the property sold is large enough to justify the additional cost the selling spouse could obtain an independent third-party appraisal review of the first appraiser or even obtain a second (or third) appraisal and use the highest value of the separate appraisals in determining the purchase price. Additionally, if there were business reasons to structure the sale in a particular manner (e.g., lending, distributor, bonding or other contractual requirements), evidence of third-party consent or evaluation could help support the bona fides or adequacy of consideration received for the sale.

(c) *Sale Pursuant to a Formula Clause Operative for Gift and Estate Tax Purposes*

As discussed previously, using a formula clause in the trust and/or sale documents to define the amount of property passing to the spousal grantor trust in order to avoid a taxable gift is highly recommended. The type of formula clause used could have an impact on the ability to argue that it is effective for estate tax purposes, as well as gift tax purposes. A formula clause that defines the amount of property transferred

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[212] Todd Steinberg, Jerome M. Hesch & Jennifer M. Smith, *Grantor Trusts: Supercharging Your Estate Plan*, 32 TAX MGMT. EST., GIFTS, & TR. J. 66 (2007).

(such as 40% of ABC, LLC) with a formula allocation between taxable (the grantor trust) and non-taxable recipients (a charity, for example), may require a complex determination of the amount that the non-taxable recipient should receive. Several decades could elapse between the date of the sale of property to the spousal grantor trust and the date of death of the selling spouse, when the issue of a sale for full and adequate consideration could be raised by the IRS pursuant to an estate tax audit. This could be even more difficult if the entity that was transferred made regular distributions that were allocated over the years based on the valuation on the date of the sales transaction. A formula clause which defines the amount of property transferred based on a certain dollar amount, such as the clause approved by the Tax Court in *Wandry v. Commissioner*[213] may be a better alternative. In a Wandry-type of formula clause, the amount of property transferred is fixed by reference to a particular dollar amount, and any property in excess of this dollar amount is retained by the transferor. If, at the selling spouse's death, the IRS argues that there was some gift element to the initial sales transaction, it will be easier to determine the division of the property between the selling spouse and the spousal grantor trust because the selling spouse has never parted with any excess value. Since the selling spouse in this scenario retained any excess value that the IRS might argue for in the estate audit, it is entirely consistent for the selling spouse to have received the entity distributions on this property during the selling spouse's lifetime.

(d) *Disposition of the Selling Spouse's Retained Interests in the Spousal Grantor Trust Prior to Death*

As discussed earlier, adequate disclosure of an installment sale to a spousal grantor trust as a non-gift completed transaction may be sufficient to start the gift tax statute of limitations on the sale. After the passing of the statute of limitations, the IRS would be prevented from making any determination that the spousal grantor trust sale resulted in a taxable gift, whether complete or incomplete. The running of the statute of limitations should effectively resolve any question as to whether the selling spouse made a transfer to the spousal grantor trust for gift tax purposes.

Although the running of the statute of limitations for gift tax purposes would not prevent inquiry into a taxable transfer for estate tax purposes, application of Sections 2036 and 2038 is determined based on

[213] Wandry v. Comm'r, T.C. Memo. 2012-88, 103 T.C.M. (CCH) 1472 (2012), *nonacq.* 2012-46 I.R.B. 543.

the facts in existence at the time of the selling spouse's death.[214] As a result, subject to Section 2035's three-year lookback rule, no part of the trust property should be included in the selling spouse's estate if the selling spouse possesses or retains no powers or interests that otherwise would cause inclusion under Sections 2036 or 2038. Estate inclusion should be avoided even if any potential transfer is determined to have been an incomplete gift that became complete by reason of something other than the selling spouse's death because the running of the statute of limitations for gift tax purposes would bar the IRS from claiming that there was an incomplete gift on the sale.[215]

If the gift tax statute of limitations has run, Sections 2036 and 2038 would be inapplicable if the selling spouse's retained interest as a trust beneficiary, a trustee, or holder of a special testamentary power of appointment terminates more than three years prior to death, even if the initial transfer was an incomplete gift.[216] If the gift tax statute of limitation has not run because the transaction was not adequately disclosed on a gift tax return and the selling spouse retained sufficient interests or powers to cause any potential gift to be incomplete, the transaction could be reported as a completed non-gift transaction upon termination of the selling spouse's retained interests or powers, which would start the running of the gift tax statute of limitations at that time. Termination of the selling spouse's interests or powers in the trust would complete any potential incomplete gift to the trust, and adequate disclosure on a timely filed gift tax return would start the period of time for determining whether the selling spouse made a gift upon the sale to the spousal grantor trust.

Even if the gift tax statute of limitations has run on the sale, however, the selling spouse's voluntary transfer or relinquishment of his or her beneficial interest in the spousal grantor trust will likely be treated as a gift by the selling spouse to the other trust beneficiaries.[217] How-

[214] *See, e.g.*, PLR 9644053 (Aug. 1, 1996) (whether a donor has retained any interest that will cause inclusion in the donor's gross estate under § 2036 will be based on the facts and circumstances that exist on donor's death).

[215] *See* Treas. Reg. § 25.2511-2(c), (f) (incomplete gift by reason of donor's reserved power to change trust beneficiaries becomes complete for gift tax purposes upon relinquishment or termination of power to change trust beneficiaries occurring other than by donor's death).

[216] I.R.C. § 2035. *See also* Treas. Reg. § 25.2511-2(g) (suggesting that incomplete gift results where donor transfers property to himself as trustee and retains beneficial interest in trust property or a nonfiduciary power to change trust beneficiaries).

[217] *See*, *e.g.*, PLR 8905035 (Nov. 4, 1988) (ruling that sole beneficiary's release of right to receive discretionary distributions of income and principal results in taxable gift which should be valued under general principles in Treas. Reg. § 25.2512-1); PLR 8034095 (May 29, 1980) (ruling that husband's relinquishment of income interest in trust created by spouse would be a taxable gift to remaindermen).

ever, if a third-party independent trustee decants the spousal grantor trust assets to a trust over which the selling spouse is neither a beneficiary, trustee, or the holder of a special testamentary power of appointment, this may successfully avoid the application of Sections 2036 and 2038 at the death of the selling spouse, without the selling spouse being treated as making a gift to the other trust beneficiaries. If one of the primary objectives of a sale to a spousal grantor trust was to provide for financial security to the selling spouse, future decantings by an independent trustee to trusts for the selling spouse's children, spouse, or charities by an independent trustee could be used to transfer the entire trust property, or to bleed off the amount of trust property that might otherwise be subject to estate inclusion under Sections 2036 and 2038. These decantings could help minimize the amount that may be included in the selling spouse's estate, if there was an excess gift. The trust could also contain provisions providing for termination of the selling spouse's rights or interests, such as at a certain age, or granting an independent trustee or a trust protector the authority to cause an early termination of the trust sufficient to cut off the selling spouse's retained powers or interests (e.g., by treating the selling spouse as deceased for all purposes of the trust).

(e) *Sale Between Two Grantor Trusts*

As previously discussed, if the selling spouse sells property in a traditional grantor trust sale to a trust that benefits the selling spouse's descendants (the "first grantor trust"), the ability of the IRS to argue for estate tax inclusion under Sections 2036 and 2038 is more limited because the selling spouse is not a beneficiary of the first grantor trust. In a separate transaction, the spouse of the selling spouse could establish and fund a grantor trust for the benefit of the selling spouse and his or her descendants (the "second grantor trust"). If the trustee of the second grantor trust purchases the assets of the first grantor trust, the selling spouse may be in a similar position as the selling spouse in a regular spousal grantor trust sale (a beneficiary of the trust, a trustee of the trust, and the holder of a power of appointment over the trust), but possibly without the added risk of estate tax inclusion under Sections 2036 and 2038 because the selling spouse did not transfer assets to the second trust.

VI. Conclusion

In conclusion, the authors believe the following tax consequences flow from a sale of property to a spousal grantor trust. In each case it is assumed that there has been a bona fide sale of property by the selling spouse to the spousal grantor trust and a valid and enforceable note was received in exchange for the property sold.

1. The selling spouse should not recognize gain on the sale of property to a spousal grantor trust under Section 1041, even if the grantor spouse dies while the note is outstanding.
2. If the selling spouse sells property to the spousal grantor trust for full and adequate consideration, the selling spouse should not be treated as making a taxable gift to the spousal grantor trust and the assets of the spousal grantor trust should not be included in the selling spouse's estate for estate tax purposes.
3. Prior to the selling spouse's death, payments received by the selling spouse should be received income-tax-free, although interest payments will be taxable to the selling spouse and may be deductible by the grantor spouse.
4. If the grantor spouse dies while the note is outstanding the selling spouse should continue to receive installment payments on the note tax free.

In addition, the authors recommend that the sale to a spousal grantor trust structure should include the following:

1. The parties should obtain an appraisal of the property sold.
2. Practitioners should consider using a formula clause for gift and estate tax purposes.
3. Practitioners should consider designing the spousal grantor trust to give the selling spouse an interest or powers that would cause any potential taxable gift on the sale to the trust to be incomplete for gift tax purposes.
4. For gift tax purposes, a gift tax return adequately disclosing a completed non-gift transaction should be considered to begin the running of the gift tax statute of limitations and provide a discreet period of time to determine the extent, if any, that the transfer is treated as a gift (whether complete or incomplete) by the selling spouse.
5. The terms of the trust should allow or authorize an independent trustee or trust protector to decant trust assets to a new trust or otherwise terminate any retained interests or powers of the selling spouse that may cause inclusion in the selling spouse's gross estate for estate tax purposes.
6. The terms of the trust should set forth the intent and purpose for the trust to be wholly grantor to the grantor spouse during his or her lifetime.