

IRS NOTICE 2009-55: TRANSACTIONS OF INTEREST

**Robert D. Steele
Wolf Haldenstein Adler Freeman & Herz LLP
New York, New York**

On July 15, 2009, the IRS published Notice 2009-55¹ (the “Notice”), which listed transactions that it has determined to be “transactions of interest.” Persons entering into one of the listed transactions must disclose their participation in the transaction. Taxpayers who fail to disclose participation may be subject to penalties. Material advisors who fail to disclose or follow list maintenance obligations also may be subject to penalties.

The Notice sets forth four specific transactions of interest, two of which involve trust transactions. The Notice specifically states that the list may be updated and that they will be listed at www.irs.gov/businesses/corporations and click “abusive Tax Shelters and Transactions.”

Sale of Charitable Remainder Interest

One of the trust transactions of interest is set forth in detail in IRS Notice 2008-99². In this situation, a Grantor establishes a charitable remainder trust (“CRT”) and contributes appreciated assets to the CRT. (The CRT can be a Charitable Remainder Annuity Trust or a Charitable Remainder Unitrust.) The CRT then sells the appreciated assets – and the CRT is typically exempt from capital gains tax -- and invests in a traditional diversified portfolio. So far, this is not an unusual or suspect transaction -- and the Notice states that “such events alone do not constitute the transaction subject to this notice.”

The next step, however, is what triggers IRS scrutiny. The Grantor and the charitable remainderman then sell their interests in the CRT to an unrelated third party for fair market value. The trust then terminates and the buyer acquires the trust property. The Grantor claims a charitable deduction for the portion of the fair market value of the contributed assets attributable to the charitable remainder interest; again, not unusual. Grantor also claims no taxable gain from the trust sale or the asset liquidation. When the Grantor and charitable remainderman sell their interests in the CRT to the third party, Grantor claims that basis provisions under IRC §§1001 and 1014 lead to the conclusion that the uniform basis rules utilize the basis of the newly acquired diversified portfolio, not the contributed appreciated assets. The result is that the capital gain on the sale of the appreciated assets is never taxed even though a portion of the gain is distributed to the Grantor – not the charitable remainderman -- on the sale of the trust.

The 2008 Notice specifically notes that the fact pattern may vary from the prototype transaction, but the result may be the same, and the transaction is still of interest. The key concern is the coordinated sale of the Grantor's interest and the charitable remainder interest in a manner in which the Grantor claims the increased basis coupled with the termination of the trust in a coordinated transaction in order to avoid the capital gain on the earlier sale of the appreciated assets.

Turning Grantor trust status on and off

A second transaction of interest was set forth in Notice 2007-73³ and involves the turning on and off – the toggling – of Grantor trust status of a trust, specifically in

situations which allow the Grantor to claim a tax loss greater than his or her actual economic loss, or to avoid the recognition of capital gain.

The 2007 Notice explains in detail two forms of the transaction – one involving the purchase of options and the other involving the substitution of appreciated assets in a trust. The details vary significantly, but several key aspects place the transactions on the transactions of interest list.

The Grantor creates the subject trust and retains a non-contingent remainder interest in the trust, which makes the trust a Grantor trust for income tax purposes. The Grantor then sells the remainder interest to an unrelated party in a manner in which little or no gain is realized. The sale of the remainder interest, the Grantor claims, removes the trust from the Grantor trust rules and the trust then becomes responsible for income and gain generated by the trust. Transactions immediately thereafter are not taxed to the Grantor. Then, at a specified date under the trust instrument, the Grantor, in a non-fiduciary capacity, gains a power to reacquire trust property by substituting other assets of equivalent value (the “substitution power”). When the substitution power becomes effective, Grantor trust status is restored – it has been toggled back on. The buyer then purchases the income interest from the income beneficiary, giving buyer both the income interest and the remainder interest. The trust is then terminated and buyer receives the trust assets.

Depending on the variation of the transaction, the Grantor has either claimed tax losses greater than the economic loss (in the options purchase scenario) or the Grantor has avoided gain on the disposition of appreciated assets (in the substitution situation). Furthermore, all of the described transactions – from the funding of the trust through the

purchase of the income interest and termination of the trust occur within one tax year, and often within thirty days.

The 2007 Notice specifically notes that transactions fall under the Notice and must be disclosed only if Grantor trust status is terminated and subsequently toggled back to Grantor trust status. The mere termination of Grantor trust status will not attract IRS scrutiny.

¹ <http://www.irs.gov/pub/irs-drop/n-09-55.pdf>

² <http://www.irs.gov/pub/irs-drop/n-08-99.pdf>

³ <http://www.irs.gov/pub/irs-drop/n-07-73.pdf>