# Intra-Family Loans:
# Adventures in Forgiveness and Forgetfulness

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*Love is an act of endless forgiveness, a tender look which becomes a habit.*
Peter Ustinov

*Prearranged staged forgiveness of a loan is a gift of the entire loan amount.*
Internal Revenue Service

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**Introduction**

In the author's experience, estate planning practitioners (for good reason) often have only a "need to know" grasp of the income and gift tax rules implicated by the conventional intra-family loan or sale. This outline will focus on the Byzantine Internal Revenue Code[2] provisions governing intra-family loans (in particular, real estate loans), how to avoid unwanted imputed gift and income taxes under those sections, and review practical solutions to this common quandary.

This outline will not address Section 7520, which values remainder interests for gift tax purposes, because is not generally applicable to intra-family loans or sales.[3]

Although, for completeness' sake, this outline will touch on esoteric planning strategies like sales to grantor trusts, self-canceling installment notes and (so briefly) private annuities, the focus of this outline, consistent with the quotidian practice of most hard-working estate planners, will be avoiding below-market loan status under Section 7872, and structuring intra-family installment sales.

Section 7872 governs below-market loans in several circumstances, among them, loans between family members.[4] As we will see, Section 7872 is complicated, therefore not well understood and, in practice, often ignored. The problem is exacerbated in sales transactions, which implicate both the income and gift-tax safe harbor of Section 7872 and the overlapping income tax (and gift tax?) safe harbors of Sections 483 and 1274.

In general, Section 7872 treats certain bona fide below-market loans as economically equivalent to a loan bearing interest at the applicable Federal rate (AFR) coupled with a payment by the lender to the borrower of funds to pay the imputed interest to the lender. The lender is treated as making i) a loan to the borrower in exchange for a note at the AFR, and ii) a transfer of funds to the borrower of an amount generally equal to the amount of imputed interest. Although income and gift taxes are implicated, the amount

[2] All further statutory references shall be to the Internal Revenue Code of 1986 unless otherwise noted.
[3] Section 7520 prescribes the method for determining the value of any annuity, any interest for life or a term of years, or any remainder or reversionary interest; such interests are determined under tables prescribed by the Secretary, and by using an interest rate (rounded to the nearest 2/10ths of 1 percent) equal to 120 percent of the Federal midterm rate in effect under § 1274(d)(1) for the month in which the valuation date falls. This s not as easy at it sounds, since the federal mid-term rate prescribed by Section 1274 assumes semi-annual compounding, and the Section 7520 rate assumes annual compounding. To derive the Section 7520 rate from the federal mid-term rate, one must multiply the federal mid-term rate by 120%, then convert it to the rate producing an equivalent yield for annual compounding, then round to the nearest .2%. Fortunately the IRS publishes the 7520 rate monthly. For May 2007 the 7520 rate is 5.6%.
[4] There is no Code provision, however, that specifically applies intra-family loans.

of the gift and income do not always align (e.g., in the case of term gift loans, the amount treated as transferred from the lender to the borrower, which is subject to gift tax, and the amount of imputed interest payable by the borrower to the lender, which is subject to income tax, are computed differently under the statute.)

## A. SOME HISTORY

### 1. In the Beginning

Once upon a time, life was good, even grand. Gas was 20 cents a gallon, Get Smart reruns ran daily, personal interest was deductible, and clever tax advisors helped their clients drive large semi-trailers through gaping holes in the income and gift tax systems through the use of interest-free loans.

During this period of tax utopia, taxpayers used interest-free loans in a variety of ways to exploit the failure of the Internal Revenue Service ("IRS" or "Service") to, at first, *assert*, then later, *convince,* the courts that interest-free loans should be income and/or gift tax taxable transfers. This exploitation included interest-free loans:

- by C corporations (usually closely-held) to shareholders (to avoid double taxation),
- by wealthy persons to family members in lower tax brackets to permit them to invest and receive returns at lower rates,
- by employers to employees as a substitute for taxable compensation; and
- by sellers using installment sales to convert interest income to capital gain.

This tax Shangri-La lasted, for the most part, from 1913 to 1984.[5]

The IRS was slow to catch on to the potential for tax avoidance, failing to strongly assert that interest-free loans should have tax consequences until 1960, when in *Dean v. Commissioner*[6], it made its first coherent argument. In *Dean*, the Commissioner argued that since an interest-free loan did not require an interest payment, the borrower received the free use of the principal as an economic benefit that should be included in gross income. At first the courts were not moved by the IRS's position.[7] Eventually, however, the United States Court of Claims adopted the theory, although they were reversed.[8] Finally, in 1984, the IRS scored its breakthrough victory in this arena (albeit in the gift tax context), in *Dickman v. Commissioner*[9], in which the Supreme Court held that the lender's right to receive interest is a "valuable property right," and that the transfer of such a right through an interest free loan is a taxable gift.

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[5] Although Congress did address installment sale abuse in 1964 with the enactment of § 483. More on that later.

[6] 35 T.C. 1083 (1961).

[7] Generally, in this era, the government was not concerned with benefits arising from the interest free use of money; *see*, e.g., the split dollar regime blessed by Rev.Rul. 64-328.

[8] *Hardee v. United States*, 82-2 U.S. Tax Cas. (CCH) P84,656 (Ct. Cl. 1982), rev'd, 708 F.2d 661 (Fed. Cir. 1983).

[9] 41 T.C.M. (CCH) 620 (1980), rev'd, 690 F.2d 812 (11th Cir. 1982), aff'd, 465 U.S. 330 (1984).

*Dickman* touched off comprehensive below-market loan reform. Later in 1984 Congress enacted Section 7872 as a set of rules to deal with certain below-market loans. With Section 7872, Congress created artificial transfers of deemed interest between the borrower and the lender, to ensure that income was recognized by each party[10]. Although *Dickman* concerned only gift tax, Section 7872 went beyond mere codification of the *Dickman* holding, beyond the intra-family context, reaching loans to shareholders, employees and a variety of other below-market loans, for both income tax and gift tax application. By enacting Section 7872, Congress indicated that virtually all gifts involving the transfer of money or property would be valued using the currently applicable AFR[11], thereby replacing the traditional fair market value methodology of valuing below-market loans with a discounting methodology.

Section 7872 Proposed Regulations were issued in August 1985,[12] a portion of which were also adopted as temporary regulations.[13]

### 2. Section 7872 - Generally

Section 7872 applies to any transaction that 1) is a bona-fide loan, 2) is below market, 3) falls within one of four categories of below-market loans, and 4) is not within any of several exceptions. The four categories are loans 1) from donor to a donee, 2) from an employer to an employee, 3) from a corporation to a shareholder, and 4) with interest arrangements made for tax avoidance purposes.[14]

As we are concerned solely with intra-family transactions, **we shall be concerned only with gift loans**.[15]

Generally, Section 7872 will not apply to any loan which provides "sufficient" stated interest, which means that the loan provides for interest at a rate no lower than the appropriate AFR, based on the appropriate compounding period.[16]

Any gift loan subject to Section 7872 which bears a below market interest rate may have adverse tax consequences to the lender.[17] The foregone interest is treated as transferred from the lender to the borrower and then retransferred by the borrower to the lender as interest. Thus, the foregone interest is treated as a gift by the lender to the borrower and then treated as income to the lender from the borrower.

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[10] At the time, the personal interest deduction made the statute essentially revenue neutral. The loss of the personal interest deduction through the enactment of Int.Rev. Code § 163(h) under the 1986 Tax Act, however, caused income tax pain for the borrower when interest-free loans are compensatory.
[11] Int.Rev. Code § 7872(f)(2)(B).
[12] All references to "Proposed Regulations" hereafter shall be to these proposed regulations issued in 1985 for § 7872, unless otherwise noted.
[13] Prop. Regs. §§ 1.7872-1-14.
[14] Int.Rev. Code § 7872(c).
[15] Although intra-family loans certainly occur in the other contexts (employer-employee and corporation-stockholder), the majority of intra-family loans will be gift loans. Later, lengthier, versions of this outline may be expanded to include the other categories.
[16] Prop. Reg. § 1.7872-3(c)(1).
[17] As opposed to the other categories of below market loans, which have adverse tax consequences for the *borrower* and the lender.

## B. THE THRESHOLD ISSUE: A Loan, or a Gift?

The gift tax is imposed by Section 2501(a)(1) on the transfer of property by gift "by any individual, resident or nonresident." Section 2511(a) adds that this tax will apply whether the gift is "direct or indirect."[18]

Although some courts[19] and the gift tax regulations[20] stress that "gift" for gift tax purposes is *not* to be used in a colloquial, common law sense (i.e., requiring *donative intent*, as required in the income tax realm under Section 102), the case law does not always bear this out. Although donative intent is irrelevant in all but one limited circumstance,[21] as we will see, courts sometimes cannot resist the temptation to look beyond pure economics to the intent behind an intra-family transaction.

### 1. Bona Fide Loan Requirement

The threshold issue in the intra-family sale or loan context is ensuring that what the parties wish to characterize as a loan will actually be recognized by the IRS as such, rather than as an immediate gift of the entire principal.

The government presumes that a transfer of money from one family member to another is a gift.[22] The presumption may be rebutted by an affirmative showing that at the time of transfer the transferor had a real expectation of repayment and intention to enforce the debt.[23]

### 2. Factors

Case law addressing the whether debts are bona fide in the intra-family loan bad debt deduction area indicates that it is not difficult to overcome the presumption of a gift.[24] These cases[25] frequently cite most or all of the following nine factors for determining whether a loan between family members is bona fide:

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[18] The discharge of a donee's indebtedness is an example of an indirect gift.

[19] *See*, e.g., *CIR v. Wemyss*, 324 US 303, 306 (145), wherein the Supreme Court held donative intent is not a requisite of a taxable gift under Int.Rev. Code § 2501(a)(1).

[20] Treas. Reg. § 25.2512-8 provides that transfers are treated as gifts "to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefore."

[21] Under the "business transaction exception" a transfer in the ordinary course of business will not be a taxable gift even though the consideration received is less than full and adequate, if the taxpayer can prove that no gift was intended, i.e. he or she made a bad business deal.

[22] *Harwood v. Com'r*, 82 T.C. 239, 258 (1984), affd. (9th Cir. 1986) 786 F.2d 1174, cert. den. (1986) 479 U.S. 1007 [107 S. Ct. 645, 93 L. Ed. 2d 701].

[23] *Estate of Van Anda v. Comr.,* 12 T.C. 1158, 1162 (1949) affd. per curiam 192 F.2d 391 (2d Cir. 1951).

[24] *See* Gutierrez, *Shore Up Potential Deduction For Intrafamily Loan*, Practical Tax Strategies (Nov. 2000)(citing *Schmeider*, T.C. Memo 1984-56), surveying cases in the bad debt deduction arena.

[25] In addition to the bad debt cases surveyed by Professor Gutierrez, many others in the bona fide loan arena cite the same nine factors; *See*, e.g., *Estate of Holland v. Com'r,* T.C. Memo 1997-302; *Miller v. Commissioner*, 71 T.C.M. 1975 (1996), *aff'd*, 113 F.3d 1241 (9th Cir. 1997); *Santa Monica Pictures, LLC v. Commissioner*, T.C. Memo. 2005-104.

- The existence of evidence of a debt;
- Whether there is a fixed schedule for repayment;
- Whether interest is charged;
- Whether collateral is requested;
- The existence of a written agreement;
- Whether demand for repayment is made (forgetfulness);
- Whether the records of the parties reflect a debt;
- Whether repayments have been made; and
- Whether the debtor is solvent at the time of the loan.

A combination of factors determines the nature of the transaction; no one factor is determinative. However, the strongest factors in favor of the taxpayer are when the borrower *signs a promissory note* and when the borrower *makes payments* on the note. Where these factors were evident, transactions are much more likely to be characterized as a loan.

A recent case reiterated some of these same factors in determining that advances from a family limited partnership should be treated as equity distributions rather than being recognized as advances in return for a note. In *Estate of Rosen v. Com'r*,[26] the decedent issued a demand note with no fixed maturity date, no written repayment schedule, no provision requiring periodic payments of principal or interest, no stated collateral, and never intended to repay the advances (which were made to meet the decedent's daily needs). The decedent made no repayments during her lifetime, and no demand for repayment was made. Only one note was prepared during lifetime even though numerous "advances" were made from the FLP. Furthermore, the decedent had no ability to honor a demand for repayment, and repayment of the note depended solely on the FLP's success.

In the context of a sale to grantor trust, the issue is whether the note from the trust to the grantor constitutes debt or equity. If the note that is received from the trust is treated as debt rather than equity, the trust assets should not be included in the grantor/seller's gross estate under Section 2036. One commentator[27] has reported that he has several cases in which the IRS is taking the position that notes given by grantor trusts in exchange for partnership interests should be ignored, based on the assertion that the "economic realities of the arrangement … do not support a part sale," and that the full value of the partnership interest was a gift not reduced by any portion of the notes.[28]

### 3. Forgiveness

A common method for making annual exclusion gifts to family members is for a relative to make a loan and forgive note payments as they come due. While this practice is widespread, it is not necessarily safe: the IRS will attack when the facts are stacked in its favor. The key to avoiding characterization of the loan as a gift is to avoid any implication that the intent to forgive was part of a prearranged plan to avoid gift tax.

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[26] T.C. Memo 2006-115.
[27] Porter, *Current Valuation Issues*, AICPA Adv. Est. Pl. Conf. ch. 42 at 51 (2004).
[28] This position conflicts with Treas. Reg. § 25.2512-8, which provides that transfers are treated as gifts "to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefore."

Some authority has allowed the annual exclusion to apply to each annually forgiven payment under an installment contract. In *Estate of Kelley*[29] the Tax Court held that forgiving annual payments under an enforceable, secured installment sales contract qualified for the annual exclusion, even though the forgiveness of each payment constituted only partial forgiveness of the debt. Likewise, in *Haygood v. Commissioner,*[30] the Tax Court held that the forgiveness of separately enforceable notes on the same debt constituted separate gifts that qualified for the annual exclusion. In both cases, the facts strongly suggested that the seller intended to forgive the buyer's payments. However, the Tax Court, in consistently holding against the IRS, has focused not on the intent to forgive but on the enforceability and adequacy of the notes.[31]

These cases have been criticized by other courts that hold that the mere promise to pay in the future, accompanied by an implied understanding that such promise will not be enforced, is not afforded significance for Federal tax purposes, is not deemed to have value, and does not represent adequate and full consideration in money or money's worth.[32]

In the intra-family installment sale context, the IRS has consistently contended that such sales are actually gifts if payments are forgiven, and has non-acquiesced to the *Kelley* and *Haygood* decisions. The IRS position was stated in Revenue Ruling 77-299, issued at the same time as the non-acquiescence. In that matter, a grandparent sold real property to grandchildren in exchange for installment notes secured by mortgages. The plan, *as described in a letter by the attorney to all parties*, was for the grandparent to forgive the annual payment as an annual exclusion gift to the grandchildren. There was no intent to collect on the notes. The IRS did not necessarily find that the notes were legally unenforceable, but still held that the intent to forgive negated the value of the consideration received in the sale, and that the transaction was a disguised gift rather than bona fide sale.[33]

Many commentators believe that the Tax Court position is the better analysis,[34] because, consistent with Section 2511, it focuses on the adequacy of the consideration, not the lender's intent, which should only be relevant to the extent it shows that the note was not bona fide and enforceable. In practice, taxpayers tend to prevail, except in matters with extreme fact patterns.[35] This outcome reflects reality; even if the lender intends to forgive

[29] *Estate of Kelley v. Com'r*, 63 T.C. 321, 325 (1974), nonacq. 1977-2 CB2.
[30] *Haygood v. Com'r*, 42 T.C. 936, 943 (1964), nonacq. 1977-2 CB2.
[31] *See* Zaritzky & Aucutt, *Structuring Estate Freezes: Analysis With Forms* (Warren Gorham & Lamont) Installment Gifts, § 12.03[2][b] (Nov. 2006) (hereinafter, "Zaritzky & Aucutt")(citing, among others, *Estate of Kelley)*. The *Kelley* and *Haygood* Tax Court cases distinguished *Estate of Deal v. Com'r*, 29 T.C. 730 (1958), in which the intent to forgive notes at time they were received caused gift treatment at outset. The IRS cited the *Deal* case in support of Rev.Rul. 77-299, discussed below.
[32] *Miller v. Com'r.,* T.C. Memo 1996-3, at 19 (1996) (citing *Estate of Maxwell v. Com'r*, 98 T.C. 594, at 604-605 (1992), affd. 3 F.3d 591 (2d Cir. 1993); *Estate of Musgrove v. United States*, 33 Fed. Cl. 657, 664 (1995)).
[33] *See* also FSA 1999-837 (if intent to forgive loan as part of prearranged plan, loan will not be treated as consideration and donor makes gift to the full extent of the loan).
[34] E.g., Zaritsky & Aucutt, *supra*; Henkel: *Estate Planning and Wealth Preservation: Strategies and Solutions*(Warren Gorham & Lamont), ¶28.05[2][a] Periodic Forgiveness (November 2006).
[35] Such as in Rev. Rul 77-299, where, prior to the transaction, the attorney outlined, in writing, the plan to forgive payments annually.

the entire loan, 1) he is free to change his mind at any time (ensuring good behavior on the part of the obligor), 2) the note is subject to seizure by creditors or a bankruptcy trustee, who will surely enforce it, and 3) if the lender dies, his executor will be under a duty to collect the note.

### 4. Renegotiating the Note

One factor tending to indicate that a loan is not bona fide, is the exchange, during periods of falling interest rates, of a note for a new note with the same principal amount at a lower interest rate. Some practitioners are unconcerned with refinancing an intra-family loan to a lower rate if the loan allows pre-payment (almost all do, or, if silent, state law permits). More cautious advisors advise against this practice, however,[36] based on the plain economic reality that the parent has traded for a less valuable asset. The donor may safeguard against potential IRS gift argument by renegotiating the terms of the note to compensate the parent for the lower interest rate; perhaps by paying down the principal amount, shortening the maturity date, or adding more attractive collateral. The IRS has provided no direct authority on this issue. The Proposed Regulations include a section entitled "Treatment of renegotiations",[37] but merely reserves the subject for later guidance, which has not been forthcoming.

### 5. Bad Debt Deduction

The factors cited above in Section 2 apply also in the context of the Section 166 bad debt deduction. An intra-family debt that becomes wholly worthless during the taxable year may be deductible under Section 166 if it is bona fide. Treasury Regulations define a bona fide debt as one "based upon a valid and enforceable obligation to pay a fixed or determinable sum of money."[38] Therefore, if the lender plans to deduct the loss from a bad loan to a family member, the loan should be structured with the factors enumerated above in mind.

Unfortunately, the deduction for non-business[39] bad debt is a short-term capital loss, regardless of how long it has been held.[40] Non-business bad debt must also become wholly worthless during the taxable year. Because of the potential for abuse arising from the family relation, courts have strictly interpreted the wholly worthless requirement.[41]

## C. IS IT A *GIFT* LOAN?

A below market loan is a gift loan if the forgoing of interest "is in the nature of a gift"[42] as defined under the gift tax.[43] The IRS *assumes* that a transfer of money from one family member to another is a gift.[44]

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[36] *See*, e.g., Benjamin Feder, *The Promissory Note Problem*, 142 Trusts and Estates 10 (Jan. 2003).
[37] Prop. Treas. Regs. §1.7872-11(e).
[38] Treas. Reg. § 1.166-1(c).
[39] The case in most intra-family loan situations.
[40] Int.Rev. Code § 166(d)(1)(B).
[41] *See, e.g.*, *Buchanan v. U.S.* 87 F.3d 197 (7th Cir. 1996).
[42] Int.Rev. Code § 7872(f)(3).
[43] Prop. Reg. § 1.7872-4(b)(1).
[44] See fn. 20, supra.

A loan can be a gift loan whether the lender is a natural person or an entity and whether, apart from the loan, the parties are related or unrelated,[45] or whether the loan is direct or indirect.[46]

An important assumption of this outline is that, unless indicated otherwise, we are discussing intra-family "gift loans" under Section 7872(c)(1)(A), as opposed to compensation related loans[47], corporation-shareholder loans[48] or tax-avoidance loans.[49]

## D. AVOIDING BELOW-MARKET GIFT LOAN STATUS UNDER SECTION 7872

The level of most practitioners'[50] mastery of this area often begins and ends with one concern: keeping a loan from being characterized as below-market -- and, therefore, in the context of this outline, a taxable gift[51] and taxable income to lender -- under Section 7872. The coping mechanism developed by many to blunt the awful truth about the complexity of Section 7872 is the cursory knowledge of Section 1274(d), i.e. that "a 0-3 year note is subject to the short term AFR, a 3-9 year note is subject to the mid-term AFR, and a 9+ year note is subject to the long-term AFR." We will expand on this here.

A (bona fide) gift loan is "below market" if the lender does not charge a rate at least the rate of interest required under Section 7872. The rate required under Section 7872 is tied to the applicable Federal rate (AFR), the lynchpin of the IRS below-market loan scheme. The AFR is determined under Section 1274(d).

### 1. The AFR

The AFR is determined and published monthly by the IRS, usually around the 20th day of the preceding month, based on the average yield for treasuries with the applicable remaining maturity periods for the one-month period ending on the 14th of the month. As mentioned above, there are three federal rates, a short term rate that is the AFR for obligations maturing three years or less from the issue date, a mid-term rate for obligations with terms in the range 3 to 9 years, and a long-term rate for obligations maturing more than nine years from issue.

The AFRs are based on annual, semiannual, quarterly, and monthly compounding of interest. The more often a loan is compounded, the more valuable it is to the lender; therefore, interest rates required by the statutes correspond to the length of the

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[45] Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts* (Warren, Gorham and Lamont) (Nov. 2006)(hereinafter, "Bittker & Lokken"), ¶55.2.4; Prop. Reg. §§ 1.7872-4(b)(1) and (b)(2).
[46] Int.Rev. Code § 2511(a).
[47] Int.Rev. Code § 7872(c)(1)(B).
[48] Int.Rev. Code § 7872(c)(1)(C).
[49] Int.Rev. Code § 7872(c)(1)(D).
[50] Present company included.
[51] Section 7872 covers four types of loans. This outline addresses only gift loans. Thus, because we are not concerned with below-market loans deemed to be compensation or dividends, we do not need to learn how to calculate OID under Sections 1273 and 1274 until we address sales transactions that fall outside of Section 7872 later in the outline.

compounding period – the shorter the period, the lower the required rate. For example, nine percent compounded annually is equivalent to 8.62 percent compounded daily.

The appropriate AFR depends on the loan's terms. If interest payments or compoundings are at intervals other than those for which rates are published, the rate for the next longest interval for which rates are published may be used. For example, the monthly rate can be used for a note providing for daily compounding, the quarterly rate can be used for bi-monthly interest payments.[52]

**2. Demand Gift Loans**

A loan is a demand loan if it is "payable in full at any time on demand of the lender" or "within a reasonable time after the lender's demand."[53]

As we will see, the rules of Section 7872 are fairly straightforward in the context of term loans. Demand loans are more problematic.

a. **Challenges**

Usually, the AFR for a demand loan is the federal short term rate in effect for the period the amount imputed by Section 7872 (referred to as "forgone interest") is being determined. This is because the lender is effectively protected against rate fluctuations by the nature of an arm's length demand loan. Section 7872 provides that interest on the hypothetical arm's length loan outstanding for any period during the calendar year would be deemed paid annually on December 31. Thus, with a loan outstanding from April 4 to November 12, the lender is deemed to require payment of interest on December 31.

Where the principal amount of a demand loan is outstanding for a full calendar year, the proposed regulations provide that a "blended rate" shall compute the amount of sufficient interest for the year.[54] The rate is applied to the principal balance outstanding as of January 1, and reflects semiannual compounding of the AFR effective for January, expressed on the basis of semiannual compounding, and such rate for July. The blended rate is announced in the latter part of June. [55]

Since the AFR is recomputed monthly, a demand note might technically be below-market for any month during which it bears interest at a rate lower than that month's AFR. However, *forgone interest* (the *measure* of the gift once the loan fails the below-market *test*) is *computed* under the Proposed Regulations with rates determined once or twice a year.[56] Unfortunately, the Proposed Regulations on the *testing* procedures were issued

[52] Alternatively, a rate precisely appropriate for the note's payment or compounding interval can be computed. *See* Bittker & Lokken, ¶53.2, note 5.
[53] Int.Rev. Code § 7872(f)(5); Prop. Reg. § 1.7872-10(a)(1).
[54] Prop. Reg. § 1.7872-13(a).
[55] The blended rate for 2006 was 4.71%. Rev. Rul. 2006-35, Table 6.
[56] Nomenclature alert: At the time the Proposed Regulations were drafted, the AFR was determined twice a year and was effective for the six-month period following the announcement. The Proposed Regulations refer to this as the "federal statutory rate." Soon after the Proposed Regulations were issued, the IRS decided to determine the AFR monthly. What the Proposed Regulations refer to as the "alternate rate" is this monthly AFR; the "alternative rate" became the statutory rate under § 1274(d) through an amendment to the statute

before the most recent amendment to Section 7872, which changed the statutory period for AFR adjustment from semi-annually to monthly. Therefore there is no definite method for testing demand loans.

One reputable authority infers the following procedure for testing whether a demand loan is below-market: A demand loan is not below-market for a particular semiannual period (January -- June or July -- December) if it bears interest at a rate at least equal to the lesser of 1) a blended rate published annually by the IRS, or 2) the Federal short-term rate for the first month of the semiannual period (January or July). For the semiannual period during which the loan is made, the loan is not below market if the rate equals or exceeds the Federal short-term rate for the month in which the loan is made, *even if this rate is lower than both the annual blended rate and the rate for the first month of the semiannual period.*[57]

b. **Variable Rate Demand Loans**

As a consequence, no fixed rate can be certain to be sufficient for as long as the loan is outstanding; a loan that is above market rate can quickly become below-market if interest rates rise and the note does not provide for periodic interest-rate adjustments.

This problem may be solved by using a variable rate demand loan with a note calling for periodic revisions of the interest rate, which might be automatic.[58] Such a note may provide that the interest rate 1) for each semiannual period (January – June or July – December) is the Federal short-term rate for the first month of the period (January or July), or 2) that the rate for a year is the blended rate for the year. Either determination provides, by definition, sufficient stated interest, and therefore will never be below-market.

> **Using an index**: The Proposed Regulations provide that variable rate demand loans will provide for sufficient interest if the rate fixed by the index used is no lower than the AFR for each semiannual period or the short term AFR in effect at the beginning of the payment period (or, if the agreement so provides, at the end) of the payment or compounding period, whichever is shorter.[59] This rule applies, for example, if interest on a demand loan is compounded monthly, with the rate for each month being the Federal short-term rate for the month.

c. **The simplest safe harbor demand loan**

The simplest note would be one with a variable rate equal to the AFR in effect on the loan date with interest rate adjustment on the first day of each month. Alternatively, for simplicity, the final regulations could adopt a rule providing that there is sufficient

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in 1985 (P.L. 99-121). Thus, what the Proposed Regulations refer to as the "alternate" rate is actually the federal statutory rate. However, the (former) federal statutory rate set forth in the Proposed Regulations is still used to determine *forgone interest* under the Proposed Regulations. Effectively, since the semiannual rate is no longer determined, the IRS has adopted the January and July AFRs as substitutes for the former semiannual AFRs. And you wondered why it was so hard to understand the proposed regs?

[57] *See* Bittker & Lokken, ¶55.2.3.

[58] Prop. Reg. § 1.7872-3(c)(2).

[59] Prop. Reg. § 1.7872-3(e)(2)(i).

interest when the variable rate changes at least in six-month intervals and, at the beginning of each interval, the rate is at least equal to the AFR in effect on that date. See Exhibit A for an example of such a variable rate demand loan promissory note.

### 3. Term Gift Loans

A term loan is a loan that is not a demand loan.[60] Under the Proposed Regulations, a term loan is a loan made under an agreement that "specifies an ascertainable period of time for which the loan is to be outstanding."[61]

A term loan is below-market if "the amount loaned exceeds the present value of all payments due under the loan." The present value of the payments is determined as of the date of the loan using the AFR as the discount rate. The AFR is the Federal short-term, mid-term, or long-term rate, depending on the term of the loan, in effect on the date the loan is made.[62]

The test is simplified in the Proposed Regs, which provide that a loan is not below market if it bears "sufficient interest"; which means interest computed "on the outstanding loan balance at a rate no lower than the applicable Federal rate based on a compounding period appropriate for that loan."[63] Interest may be variable, so long as the rate is at or above the AFR at the time the loan is made and is based on an objective index.[64]

As opposed to a demand gift loan, which may fall in and out of below-market status (if not properly drafted), a gift loan for a fixed term need only qualify (for gift tax purposes) as a market loan at the time the loan is made (or when the $10,000 de minimis ceiling is exceeded). See Exhibit B for an example of a term loan promissory note.

### 4. Exemptions From 7872

#### a. De minimis Exemption

A gift loan is exempt from Section 7872 if it is made "directly between individuals" and "the aggregate outstanding amount of the loans between such individuals does not exceed $ 10,000."[65] All loans between the lender and borrower are aggregated regardless of their character (market or below-market), the date made or the rate of interest (if any).[66] If the amount of loans outstanding between individuals exceeds $10,000 at some point during the year, Section 7872 will apply to the loan for gift tax purposes regardless

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[60] Int.Rev. Code § 7872(f)(6).
[61] Prop. Reg. § 1.7872-10(a)(2). A period is considered ascertainable if it can be "determined actuarially." For example, a loan payable only on the borrower's death is a term loan because the borrower's life expectancy is actuarially determinable.
[62] Int.Rev. Code § 7872(f)(10); Prop. Reg. § 1.7872-8(b)(1).
[63] Prop. Reg. § 1.7872-3(c)(1).
[64] Prop. Reg. § 1.7872-3(e)(1).
[65] Prop. Reg. § 1.7872-8(b)(2). A loan to a Custodian under the Uniform Transfers to Minors Act is deemed to be to a natural person, but a loan to a trust does NOT qualify, even though the beneficiaries are natural persons. Prop. Reg. § 1.7872-8(b)(3).
[66] In determining the aggregate outstanding amount of loans between individuals, loans by a husband and wife to an individual borrower are treated as made by one person.

of whether the borrower subsequently reduces the loan balance: the amount of deemed gift is fixed at that point.

*i.* **Exception to the Exemption** This de minimis exemption does not apply to any gift loan "directly attributable to the purchase or carrying of income-producing assets." "Income producing assets" are defined in the Proposed Regulations as 1) an asset of a type that generates ordinary income, or 2) a market discount bond issued prior to June 19, 1984.[67]

b. **Special Income Tax Rule for Gift Loans Aggregating $100,000 or Less**

For all the days of the borrower's taxable year during which the aggregate principal balance of gift loans made directly between individuals does not exceed $100,000, Section 7872(d)(1) limits the amount of deemed interest paid by the borrower to the lender under Section 7872 to the borrower's "net investment income" for the year (as defined under Section 163(d)(4)).[68]

c. **Sections 483 and 1274**

According to Section 7872(f)(8), Section 7872 does not apply to any loan to which Sections 483 or 1274 apply. As discussed below, this exception is not nearly as straightforward as the clear language of the statute implies, and there is considerable room for interpretation (and confusion).

## E. ESTATE TAX VALUE OF NOTE

By its terms, Section 7872 seems to apply only to a determination as to whether a person has received a compensation-related loan or a gift loan. However, Section 7872(h)(2) authorizes the IRS to issue coordinating estate tax regulations with respect to term loans "made with donative intent."[69] The Proposed Regulations[70] clarify that the section applies with respect to "gift loans" under 7872(c) (i.e., loans made with donative intent that would have been subject to Section 7872 imputed interest had the lender not charged the AFR) and below-market loans (i.e., loans made with donative intent that charge less than the AFR):

> "This section applies with respect to any term loan made with donative intent . . ., regardless of the interest rate under the loan agreement, and regardless of whether that interest rate exceeds the applicable Federal rate in effect on the day on which the loan was made."

Under the Proposed Regulations, a promissory note evidencing the loan made with donative intent (whether below- or at- market) will be valued for estate tax purposes at the lesser of (1) the unpaid stated principal, plus accrued interest, or (2) the sum of the present value of all principal and interest payments due under the note, using the date of

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[67] Prop. Reg. § 1.7872-8(b)(4).
[68] Int.Rev. Code § 7872(d)(1)(E).
[69] As noted above, to date, no final or temporary regulations have been issued under Section 7872(h)(2).
[70] Prop. Reg. § 20.7872-1.

death applicable federal rate for a loan with a term equal to the remaining term of the note. Consistency requires that Section 7872 principles be applied in valuing obligations for estate tax purposes; the date of death AFR is used to determine the note's value even though applying the rate that an unrelated lender would charge for a loan with the same terms and maturity would usually result in a significantly lower valuation.

No discount will be allowable for collectibility considerations unless there has been a demonstrably "significant" deterioration of the credit-worthiness of the borrower, guarantor, or both subsequent to the initial loan.[71]

## F. FORGIVENESS: Income Tax Consequences

If a lender waives, cancels or forgives accrued interest payments, this may have income tax consequences for the lender. Interest will be treated as if it had been paid to the lender and then retransferred from the lender to the borrower "if (1) The loan would initially have been subject to Section 7872 had it been made without interest; (2) The waiver, cancellation or forgiveness does not include in substantial part the loan principal; and (3) A principal purpose of the waiver, cancellation, or forgiveness is to confer a benefit on the borrower, such as to pay compensation or make a gift . . ."[72]

The principal purpose under (3) is presumed in the case of a loan between family members "unless the taxpayer can show by clear and convincing evidence that the interest obligation was waived, cancelled, or forgiven for a legitimate business purpose of the lender who is acting in the capacity as a creditor seeking to maximize satisfaction of a claim, such as in the case of a borrower's insolvency."[73] Thus, if an individual initially makes a market-rate, bona fide loan to a family member, but later decides to make a gift of the interest payments under the assumption that she will also avoid recognition of the interest income that is not the case. The lender will recognize interest income despite the waiver, cancellation or forgiveness of the interest payments.

## G. BELOW-MARKET LOANS: What's The Damage?

### 1. Income Tax Consequences of a Below-Market Gift Loan

#### a. Investment Income Limitation for Gift Loans

If a below-market gift loan is made directly between individuals, and if the outstanding balance of all loans (of any kind) between them is not greater than $100,000, the imputed interest payment from borrower to lender for any year is usually limited to the amount of the borrower's net investment income for the year.[74] However, note that this limitation only applies for *income tax* purposes (thus, the lender is deemed to have made a gift of the full amount of the foregone interest regardless of the borrower's net investment income). The limitation applies to both the borrower's interest deduction and

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[71] *See* Prop. Reg. § 20.7872-1.
[72] Prop. Treas. Reg. § 1.7872-11(a).
[73] *Id.*
[74] Int.Rev. Code § 7872(d).

the lender's interest income, except that it applies to the lender only if "the borrower notifies the lender, in a signed statement, of the amount of the borrower's net investment income properly allocable to the loan."[75]

b. **Demand Gift Loan**

With a below-market demand loan, the amount of "forgone interest" is deemed transferred from the lender to the borrower in the form of a gift, and then retransferred by the borrower to the lender as payment of interest on December 31 (or on the date the loan is repaid). The imputed interest income is in addition to any actual interest income received from the borrower. The amount of forgone interest for any calendar year (i.e., the amount of the additional payment/interest treated as loan paid to lender) is the excess of:

- the amount of interest that would have been payable in that year if interest had accrued at the AFR, over
- any interest actually payable on the loan allocable to that year.[76]

*i.* **Demand Gift Loan Outstanding for an Entire Calendar Year**

To calculate the amount of forgone interest for a demand loan with a constant principal amount outstanding for an entire year, the forgone interest is equal to the sum of:

(1) The product of one-half of the January short-term rate based on semi-annual compounding times the principal amount of the loan; and
(2) The product of one-half of the July short-term rate based on the semiannual compounding times the sum of the principal amount of the loan and the amount described in (1).[77]

From this amount, the amount of interest actually paid during the calendar year, if any, is subtracted.

For easier computation, the IRS also publishes a "blended annual rate" that is multiplied by the principal amount of the loan outstanding to arrive at the amount from which the actual interest paid, if any, is to be subtracted.[78] This blended annual rate is published annually in July in the Revenue Procedure that announces the applicable Federal rates for that month. The excess amount over the interest actually paid is the forgone interest.

*ii.* **Demand Gift Loan Outstanding for Less Than the Entire Year.**

If a portion of the loan principal is repaid or an additional amount is loaned during the calendar year, the calculation of the forgone interest is complicated.

[75] Prop. Reg. § 1.7872-11(g)(3).
[76] Int.Rev. Code § 7872(e)(2)(A)-(B); Prop. Reg. § 1.7872-6; Reg. § 25.7872-1.
[77] Rev. Rul. 86-17, 1986-1 C.B. 377.
[78] *Id.*; Prop. Reg. § 1.7872-13(a). Note that in the case of *term* gift loans, the taxpayer is to use the AFR based on annual compounding in effect the day the loan is made, appropriate to the term to maturity, in lieu of the blended annual rate. Prop. Reg. § 1.7872-13(e)(1)(i).

The amount of this interest is calculated by using the "exact method" or the "approximate method."

The "**exact method**" is based upon a daily compounding of interest calculates the interest as "the principal amount multiplied by: (1 + I ÷ k)f -1 where:

> I = the Federal short-term rate expressed as a decimal[79]
> k = the number of accrual periods in a year; and
> f = a fraction consisting of the number of days in the period for which interest is being computed divided by the number of days in a complete accrual period."[80]

This amount should be computed separately for each month at the short-term rate for that month.[81] The exact method *must* be used in this situation (when the loan balance is not constant throughout the year) if either of the parties is not an individual or the aggregate of loans between them exceeds $250,000.

The "**approximate method**" is available to individual lenders and borrowers when the aggregate amount of loans between them is $250,000 or less. Under this method, interest is calculated by calculating the interest for a semiannual period and then prorating that amount on a daily basis to determine the amount of interest for the portion of the semiannual period the loan was outstanding.[82]

**IRS EXAMPLES:**

*Example (1).* (i) On October 1, 1984, C makes a $50,000 interest-free demand loan to D. On October 1, 1985, C makes an additional interest-free demand loan of $25,000 to D. Assume that Section 7872 applies to both loans, that the blended annual rate for 1985 is 10.45 percent, and that the applicable Federal rate based on semiannual compounding for demand loans made in October 1985, is 10.50 percent.
The amount of foregone interest for 1985 is calculated as follows:
(ii) $50,000 is outstanding for the entire year. The foregone interest on this amount is ($5,000 × .1045) = $5,225.00
(iii) $25,000 is outstanding for the last three months of 1985.

> Under the **exact method**, the amount of foregone interest on this portion of the loan is $647.86, computed as follows:
>
> $25,000 × [(1 + .1050/2) 3/6 – 1] = $647.86
>
> Under the **approximate method**, the amount of foregone interest is $656.25, computed as follows:
>
> $25,000 × (.1050/2) × (3/6) = $656.25
>
> The total amount of foregone interest is $5,872.86 ($5,225.00 + $647.86) under the exact method, and $5,881.25 ($5,225.00 + $656.25) under the approximate method.

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[79] Note, however, that for gift term loans, the amount of interest that would have been payable in that year if interest had accrued at the AFR is computed using the AFR based on *semi-annual* compounding in effect the day the loan is made, appropriate to the term to maturity, in lieu of the Federal short-term rate. Prop. Reg. § 1.7872-13(e)(1)(ii).
[80] Bittker & Lokken, ¶55.3.2; Prop. Treas. Reg. §§ 1.7872-13(b), (c) and (d).
[81] *Id.*
[82] *Id.*

*Example (2).*

On September 1, 1985, E makes a $100,000 interest-free demand loan to F. The loan agreement requires F to repay $10,000 of the principal amount of the loan at the end of each month that the loan is outstanding. Assume that Section 7872 applies to the loan and that the applicable Federal rate based on semiannual compounding for demand loans made in September 1985, is 10.50 percent.

The amount of foregone interest for 1985 is calculated as follows:

-- $70,000 is outstanding for four months.

Under the exact method, the amount of foregone interest on this portion of the loan is $2,429.05, computed as follows:

$70,000 × [(1 + .1050/2) 4/6 – 1] = $2,429.05

Under the approximate method, the amount of foregone interest on this portion of the loan is $2,450.00, computed as follows:

$70,000 × (.1050/2) × (4/6) = $2,450.00

$10,000 is outstanding for 3 months.

Under the exact method, the amount of foregone interest on this portion of the loan is $259.14, computed as follows:

$10,000 × [(1 + .1050/2) 3/6 – 1] = $259.14

Under the approximate method, the amount of foregone interest on this portion of the loan is $262.50, computed as follows:

$10,000 × (.1050/2) × (3/6) = $262.50

-- An additional $10,000 is outstanding 2 months.

Under the exact method, the amount of foregone interest on this portion of the loan is $172.02, computed as follows:

$10,000 × [(1 + .1050/2) 2/6 – 1] = $172.02

Under the approximate method, the amount of foregone interest on this portion of the loan is $175.00, computed as follows:

$10,000 × (.1050/2 × (2/6) = $175.00

-- A final $10,000 is outstanding for 1 month.

Under the exact method, the amount of foregone interest on this portion of the loan is $85.65, computed as follows:

$10,000 × [(1 + .1050/2) 1/6 – ] = $85.65

Under the approximate method, the amount of foregone interest on this portion of the loan is $87.50, computed as follows:

$10,000 × (.1050/2 × (1/6) = $87.50

-- The total amount of foregone interest is $2,945.86 under the exact method, and $2,975.00 under the approximate method.

### *iii.* **Demand Gift Loan With Fluctuating Loan Balance**

This is a practical issue for most practitioners in administering a note, when the borrower-child pays as the spirit moves her. According to the Proposed Regulations,

> "[i]f a demand loan does not have a constant outstanding principal amount during a period, the amount of foregone interest shall be computed according to the principles [applying to loans outstanding less than the entire year], with each increase in the outstanding loan balance being treated as a new loan and each decrease being treated as first a repayment of accrued but unpaid interest (if any), and then a repayment of principal."[83]

[83] Prop. Reg. §§ 1.7872-13(c) and (d).

**EXAMPLES**:

*Example (1).* On January 1, 1986, parent P makes a $200,000 gift term loan to child C. The loan agreement provides that the term of the loan is four years and that 5 percent simple interest is payable annually. Both P and C are calendar year taxpayers, and both are still living on December 31, 1986. Assume that the Federal mid-term rate based on annual compounding in effect on January 1, 1986, is 11.83 percent. The loan is a below-market loan.

The amount of foregone interest for each year is $13,600.00, computed as follows:

($200,000) × .1183 = $23,660.00

$23,660.00 – $10,000.00 = $13,660.00

For gift tax purposes, an imputed gift is treated as made on January 1, 1986, and is equal to the excess of the amount loaned ($200,000) over the present value of all payments due under the loan, discounted at 11.83 percent compounded annually ($153,360.82), or $41,639.82.[84]

*Example (2).* Assume the same facts as in Example (1) except that C repays the loan on September 30, 1987, along with an interest payment of $7,500. For income tax purposes, the imputed payments are treated as transferred on December 31, 1986 and September 30, 1987.

The amount of the imputed payments for 1986 are the same as in Example (1).

For 1987, under the exact method the amount of foregone interest is $9,994.73, computed as follows:

$200,000 × [(1 + .1183) 9/12 – 1] = $17,494.73

$17,494.73 – $7,500 = $9,994.73

For gift tax purposes, the imputed gift is treated as made January 1, 1986, and is the same as in Example (1).

### c. Term Gift Loan

Although Section 7872(b) provides that a term loan with a below market interest rate will be treated as having original issue discount (OID) at the time the loan is made,[85] the Proposed Regulations[86] provide that for *gift* term loans the foregone interest demand loan rules apply.[87] The OID rules rest on the premise that the present value of the borrower's promise to repay is less than the amount loaned; they are appropriate only if the borrower is assured the use of the lender's money for a fixed term.

Under the demand loan rules applied to term gift loans, as opposed to the OID scheme, forgone interest accrues on the full amount loaned, and none of the original principal is re-characterized as a non-loan payment. Congress decided that demand loan rules should also determine the income tax consequences of gift term loans "because, in light of the familial or other personal relationship that is likely to exist between the borrower and the lender, the technical provisions of the loan, such as the maturity of the loan, may not be viewed as binding by the parties." This regime relieves donors and donees of the burden of coping with the OID rules that apply to non-gift term loans.[88]

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[84] For rules for determining the computation of present value, see § 1.7872-14.

[85] The lender is treated as having transferred to the borrower the excess of the amount of the loan over the present value of the payments required to be made under the terms of the loan.

[86] Prop. Treas. Reg. § 1.7872-6(a).

[87] Except for minor calculation adjustments as provided in Prop. Reg. § 1.7872-13(e)(1).

[88] Bittker & Lokken, ¶55.3.2, citing Staff of Joint Comm. on Tax'n, 98th Cong., 2nd Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 533 (Comm. Print 1984).

d. **Reporting Requirements**

Each year, a lender must report the interest income imputed to him on his income tax return, attaching a statement:

- Explaining that the interest income relates to an amount includible in his income by reason of Section 7872;
- Providing the name, address and taxpayer identification number of each borrower;
- Specifying the amount of imputed interest income attributable to each borrower;
- Specifying the mathematical assumptions used (*e.g.*, 360 day calendar year, the exact method or the approximate method for computing interest for a short period) for computing the amounts imputed under Section 7872; and
- Including any other information required by the return or the instructions thereto.[89]

The borrower must attach a similar statement to her income tax return for a taxable year in which the borrower claims a deduction for an amount of interest expense imputed under Section 7872.

**2. Gift Tax Consequences of Below-Market Gift Loan**

a. **Demand Gift Loan**

For a below-market demand gift loan, the amount of the gift is equal to the "forgone interest" treated as transferred from the lender to the borrower and retransferred from the borrower to the lender as payment of interest, calculated as provided in section E.1.b. above. The gift is deemed to be made on the last day of the calendar year for each year that the loan is outstanding, or the day the loan is repaid if it is repaid during the year.[90]

b. **Term Gift Loan**

For income tax purposes, below-market term and demand gift loans are, for the most part, treated the same. For gift tax purposes, however, demand gift loans and term gift loans are treated differently:[91] the amount of a deemed gift is calculated using a different methodology, and the gift is recognized at a different time than the income.[92]

*i.* **Amount**

For gift tax purposes, with a term gift loan, the OID rules apply[93] and the lender is treated as making a gift to the borrower in an amount equal to the excess of the principal amount of the loan over the present value of all payments that are required to be made under the terms of the loan. Present value is as determined under Prop. Reg. section 1.7872-14. The discount rate for the present value computation is the AFR in effect on the day the loan is made.

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[89] Prop. Reg. § 1.7872-11(g).
[90] Int.Rev. Code § 7872(a); Prop. Treas. Reg. §§ 25.7872-1 and 1.7872-6(b)(5).
[91] Prop. Treas. Reg. § 1.7872-7(a)(2).
[92] This also means that below market term loans are treated differently under the income tax and gift tax regimes.
[93] Prop. Treas. Reg. § 1.7872-7(a)(2).

$$PV = \frac{FV}{(1+i)^n}$$

The above calculates what present value (PV) would be needed to produce a certain future value (FV) if interest of i% accrues for n periods.

The simplest present value example given in the proposed regulations is:[94]

> *Example (1).*
>
> (i) On July 1, 1984, corporation A makes a $200,000 interest-free three-year term loan to shareholder B. The applicable Federal rate is 10-percent, compounded semiannually.
>
> (ii) The present value of this payment is $149,243.08, determined as follows:
>
> $$\$149{,}243.08 = \frac{\$200{,}000}{[1 + (.10/2)]^6}$$
>
> The excess of the amount loaned over the present value of all payments on the loan ($200,000 – $149,243.08), or $50,756.92, is treated as a distribution of property (characterized according to Section 301) paid to B on July 1, 1984.

*ii.* **Timing**

The gift is treated as being made on the first day on which Section 7872 applies to the term loan.[95] Thus, while with a below-market *demand loan* the lender makes a gift **each year** the loan is outstanding, with a below-market *term loan* the lender makes the total gift in the first year of the loan. This can make a significant difference if the lender plans on using her gift tax annual exclusion to shelter the gift to the borrower. While the imputed gift with respect to a demand loan may be less than the annual exclusion amount, the imputed gift with respect to a term loan in the first year of the loan could exceed that amount.

## H. INTRA-FAMILY *SALES*

### 1. Installment Sales

Planners have long used intra-family sales to freeze the estate tax value of the assets sold, and to provide liquidity by replacing an illiquid asset with cash. These advantages are balanced against the disadvantages of a sale, among them the recognition of gain, loss of control over the asset, and loss of income from the asset. To avoid the immediate recognition of gain, sales to family members are often structured as installment sales.

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[94] Although the calculation is for a below-market loan to an employee, the concepts are the same for calculating the amount of a gift for a below-market intra-family gift loan.

[95] Int.Rev Code § 7872(b)(1); Prop. Treas. Reg. §§ 25.7872-1 and 1.7872-7(a).

The installment method permits a sale of property without the seller being required to report the gain until the actual receipt of the payments (subject to the exceptions noted).

Although the installment sale method will generally be available, there are significant exceptions. In particular, the installment sale method is not available for a sale of marketable securities and other property regularly traded on an established market.[96] It is also not available to the extent that the gain in question is depreciation recapture and may not be available at all if the sale consists of depreciable property and is to a controlled entity.[97] Finally, sales of inventory or dealer property will not generally qualify for installment treatment.[98]

Even if the installment method is available, there may be limits on its use. First, interest may be charged on the deferred tax liability if the aggregate face amount of all of the seller's installment obligations from sales during the year exceeds $5,000,000.[99] Also, a pledge of the installment note will trigger gain recognition.[100] Lastly, a gift or other disposition of the installment note, or the sale of the purchased property by a related purchaser within two years of the installment sale, may cause the balance of the deferred gain to be recognized.[101]

a. **Which Interest Rate Safe Harbors Apply?**

One primary, unresolved, issue involving gift loans under Section 7872 involves sales of property that may be regarded as part-sale, part-gift.

> For example,[102] assume a mother of an adult child decides to sell a tract of undeveloped land for $500,000, paid $100,000 in cash and $400,000 by a 15-year promissory note at six percent per annum, compounded semi-annually. Total payments over the term of the note will be $907,905.
>
> Assume the AFR is ten percent.
>
> The present value of the payments under the contract, discounted at the AFR, is $234,243. The difference between this amount and the loan amount, $400,000, is $165,757. Because the present value of the total payments under the loan is less than the amount loaned, this is a below-market loan under Section 7872, at least according to the IRS.

Under similar circumstances, however, taxpayers have argued, and the Seventh Circuit has agreed, that no gift has occurred in the example because the transaction falls under the income tax safe harbor of Section 483(e) of the Code, which provides a six-percent safe harbor for land sales between relatives.[103] The IRS, the Tax Court, and the Eighth

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[96] Int.Rev. Code § 453(k)(2).
[97] Int.Rev. Code §§ 453(i) and 453(g).
[98] Int.Rev. Code § 453(b)(2).
[99] Int.Rev. Code § 453A.
[100] Int.Rev. Code § 453A(d).
[101] Int.Rev. Code §§ 453B and 453(e).
[102] *See* John A. Lynch, Jr., *Taxation of Below-Market Loans Under § 7872: This Could be a Lot Simpler!* 21 Akron Tax J. 33, at 67.
[103] *Ballard v. Com'r*, 854 F.2d 185 (7th Cir. 1988).

and Tenth Circuits, however, disagree, and would assert that Section 483(e) only provides an income tax safe harbor, NOT a gift tax safe harbor.

What has happened to the relatively straightforward scheme outlined to this point in this paper? We have departed from the relative safety of intra-family loans and stepped into the murk of intra-family sales. This area has not garnered much attention in the past decade or so because of the low interest rate environment. In contrast to June 1981, when the average prime rate was 20.3%, today six percent is not a valuable safe harbor.[104] However, if and when interest rates (and therefore, the AFR) rise, the sleeping bear may be roused.

### *i.* The statutes

As noted above, prior to the enactment of Section 7872, Congress first entered the realm of interest rate safe harbors in the context of installment sales. Congress enacted or amended income tax statutes Sections 483 (1964, amended in 1984) and 1274 (1984) to address a problem not involving the gift tax. Under these statutes, certain debt instruments issued in connection with installment sales must bear interest at the AFR to ensure that it provides "adequate stated interest." The statutes were aimed at installment sales transactions where the parties opted to inflate the sales price and impose reduced or no interest payments. This allowed the seller to convert ordinary income to capital gain and allowed the buyer to treat all payments as basis. Thus, although they employ the same methodologies for imputing interest as Section 7872, these sections ostensibly address not valuation issues, but rather characterization of income.

#### (a) Section 7872

Section 7872(f)(8) explicitly states that Section 7872 does ***not*** apply to a loan given in consideration for the *sale or exchange of property*; this area is, at first glance, covered by Code Sections 483 and 1274. This is so even if Sections 483 and 1274 do not apply by reason of exceptions or safe harbor provisions.[105] This straightforward statement is modified somewhat by the regulations and proposed regulations, and transmogrified by caselaw (see below).

#### (b) Section 1274

Section 1274 provides the general rule for income tax treatment of installment sales; it applies to a note issued in a sale or exchange unless the note is excepted from its application. Section 1274(d)(2) provides that in a sale or exchange, the appropriate AFR is the lowest such rate for the three-month period ending with the month there was a "binding contract in writing for such sale or exchange." For installment sales the appropriate AFR is based not the term of the note, but on its

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[104] In cases that spawned the conflict over which rates should be applied to avoid income tax and gift tax, for instance, the IRS has alleged applicable gift tax discount rates of eighteen percent in *Ballard v. Com'r*, 854 F.2d 185 (7th Cir. 1988), eleven percent in *Krabbenhoft v. Com'r*, 939 F.2d 529 (8th Cir. 1991) and eleven and one-half percent in *Schusterman v. United States*, 63 F.3d 986 (10th Cir. 1995).

[105] Int.Rev. Code § 7872(f)(8).

weighted average maturity.[106] The *weighted average maturity* of an obligation equals the sum of the amounts obtained by multiplying the number of complete years from the issue date until the payment is made by a fraction. The numerator of the fraction is the amount of each payment under the instrument (other than qualified stated interest), and the denominator is the stated redemption price at maturity.[107] Once an instrument's term is calculated, the discount rate used is the lowest AFR in effect during the three-month period ending with the first month a binding written contract for the transaction exists.

Section 1274(c)(3) lists exceptions to the application of the section, which exceptions include transactions to which Section 483(e) applies.

**(i) Special AFR Rules Apply to Certain Transactions**

A. **Qualified Debt Instruments** Section 1274A provides a safe harbor of 9% compounded semiannually for certain qualified debt instruments. For 2006, a qualified debt instrument included any debt instrument given in exchange for property (other than Section 38 property) that has a stated principal amount of not more than $4,800,800.[108] However, a debt instrument issued in a sale/leaseback transaction cannot be a qualified debt instrument.[109] This rate applies only to bona fide sales between unrelated parties.
B. **Sale/Leaseback Transactions** For sale/leaseback transactions involving the transferor or any related party, the discount rate is 110% of the AFR, compounded semiannually, and *not* limited to 9%.[110]

**(c) Section 483**

Section 483 applies, in limited circumstances, to debt instruments issued in a sale or exchange of property excepted from Section 1274 (see below). "Unstated interest" is determined pursuant to Section 483(b) in a manner similar to the determination of the imputed principal amount in Section 1274(b); that is, interest will be imputed to the Seller, at the appropriate AFR, by discounting all payments to the date of sale (i.e., by applying OID rules).

Generally, Section 483 applies to the most debt obligations excepted from Section 1274, which include:

- **Sales for $250,000 or le**ss.[111]

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[106] Treas. Reg. § 1.1274-4(c).
[107] *See* Treas. Reg. § 1.1273-1(f) for examples. *See* Section H.1.b.ii of this outline for definitions of these terms.
[108] Int.Rev. Code § 1274A(b), Rev. Rul. 2007-4, 2007-4 IRB 351.
[109] Treas. Reg. § 1.1274A-1(b)(1).
[110] Int.Rev. Code § 1274(e).
[111] Int.Rev. Code § 1274(c)(3)(C).

- **Sale of a farm for less than $1,000,000**.[112]

- **Sale of a Principal Residence**.[113] If a buyer uses the real property as a personal residence, he or she is exempted also from Section 483, although the seller will in most cases remain subject to Section 483.

- **Sales of *Land* Between Family Members.** Most important in the intra-family sales context is **Section 483(e)**, which provides an exception to the AFR requirement. Under Section 483(e), if a family member contracts to sell land to another family member at a price of $500,000 or less, the family members may use a ***six percent safe harbor*** interest rate.[114]

The Section 483(e) safe harbor is directly applicable to our subject matter, and has attracted the interest of taxpayers and the IRS because of the value of a six percent safe harbor in time of high interest rates. By enacting Section 483(e), Congress unequivocally bestowed favorable tax treatment to intra-family real estate sales in the context of imputed interest. The issue, discussed fully below, is whether Congress intended, or even considered, whether this favorable tax treatment should be extended to *gift tax*. Unfortunately, Section 483 contains no language that clearly excludes its application in the gift tax context.

> Practice Note: If an intra-family sale transaction does not involve real property, and therefore falls within the general ambit of Sections 1274 or 483 (as opposed to Section 483(e)), the stakes in the conflict described below are lower: the difference between the income tax safe harbor interest rates (Sections 483 or 1274) and the Section 7872 gift and income tax interest rate safe harbor is not as profound. With the income tax safe harbor statutes, the taxpayer may use the three-month AFR, an option which is not available under Section 7872. In these circumstances, the judicious practitioner will bite the bullet and use the Section 7872 rate.

*ii.* **The Regs and Proposed Regulations**

The 7872 proposed regulations "clarify" that the exception of Section 7872 from transactions where 483 or 1274 apply, set forth in 7872(f)(8), is a ***general*** rule only, and that Section 7872 ***will*** apply to such a loan if it is a gift loan that is: 1)

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[112] Int.Rev. Code § 1274(c)(3)(A).
[113] Int.Rev. Code § 1274(c)(3)(B).
[114] Int.Rev. Code § 483(e)(2) provides that a "qualified sale" means any sale or exchange of land by a person to a member of such person's family within the meaning of Int. Rev. Code § 267(c)(4), which limits a person's family to siblings, spouses, ancestors and lineal descendants. Under Treas. Reg. § 1.483-3(b)(2)(iii), if the property sold or exchanged includes any property other than land, Section 483(e) applies only to the extent that the stated principal amount of the debt instrument issued in the sale or exchange is attributable to the land (based on the relative fair market values of the land and the other property).

a demand loan[115] or 2) issued in a sale or exchange where the property will be held by the buyer for personal use and the seller does not make sales on the same terms and conditions to the general public.[116] A fixed-term mortgage note given by a child in purchasing a home from his parent is an example of a personal use note.

The scheme certainly implies, to the extent it may not be explicit, that **the statutes are mutually exclusive**. Either 1274 and/or 483 apply to the exclusion or 7872, or vice versa. Section 7872(f)(8) explicitly states that where Section 483 applies, Section 7872 shall not apply. Under narrow assumptions (intra-family gift loan in connection with a sale or exchange, for personal use property) it is fairly clear that Section 7872 applies exclusively. Unfortunately no parallel provision in Section 483 closes the loop – no provision explicitly states that where Section 483 applies, it trumps Section 7872 and therefore, as is implied, *applies for gift tax purposes* in those limited circumstances. In other words, there is no explicit statement in the statutes that where Sections 483 and/or 1274 apply, they apply to the exclusion of Section 7872 for both the income tax AND gift tax applications.[117]

For example, what about an intra-family installment sale to a child who intends to use the property for *business* use?[118] This appears to be covered by Section 483(e), and thereby completely excluded from Section 7872 income *and gift tax* treatment by Section 7872(f)(8), or so it would seem. These are the facts of the *Frazee* case.

### *iii.* **Frazee and Antecedents**

The integration of these code sections runs into darkness and fog, when, in search of a consistent policy, the courts attempt to divine the intent of Congress. In the face of Congressional silence, the courts have had a difficult time processing the issue, taking the ambiguity of the scheme and running with it, mainly against the taxpayer. The muddled result: if Section 483 or 1274 apply to an intra-family installment sale or exchange, the IRS and the courts, for the most part, do not

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[115] Prop. Regs. § 1.7872-2(a)(2)(ii)(A). *See* also Treas. Reg. §§ 1.1274-1(b)(3)(ii) and 1.483-1(c)(3)(iii), in accord.

[116] Prop. Regs. § 1.7872-2(a)(2)(ii)(C). The term "personal use" means use in other than a trade or business or in connection with an investment. Int.Rev. Code § 1275(b)(3). *See* Treas. Reg. 1.483-1(c)(3)(ii) and (iii). Note Prop. Reg. § 1.7872-2(a)(2)(ii)(C) is broader than its counterpart, Treas. Reg. 1.483-1(c)(3)(ii), in that it excludes the application of §§ 483 and 1274 to both parties to the described transaction, rather than just the obligee (seller).

[117] In fact, a line of cases has adopted this reasoning, initially prior to the enactment of 7872, and then, in the *Frazee* case, after the enactment of 7872. *See* the next section, *Frazee* and its Antecedents.

[118] One example in the Regulations misses the opportunity to further clarify the relationship between Section 7872 and its income tax counterparts. Treas. Reg. 1.1274-1(c), Example 3, assumes a term loan payment for an intra-family sale of non-farm real property, and applies Sections 1274 and 483(e) to a note in the amount of $650,000 -- ignoring the potential application of Section 7872. Adding the detail of whether the child intended to use the property for personal or business use would have been extremely helpful. As it is, assuming a business use is the only way to reconcile section (i) of this example with the Section 7872 proposed regs. Likewise, section (ii) assumes the amount not subject to Section 483(e) will be subject to Section 1274, again contradicting the Section 7872 Proposed Regulations.

respect the apparent exclusivity of the schemes, and apply both Section 7872 and the applicable income tax safe harbor statute (Section 483 or 1274).

*Frazee* was the culmination of the Service's efforts through the early 1980's and into the 1990's to restrict the safe harbors of Section 483 (and, theoretically, Section 1274) to the income tax province, against efforts of taxpayers to use the lowest safe harbor rate as a safe harbor for both income and gift tax.[119] The Service,[120] the Tax Court, Eighth[121] and Tenth Circuits[122] contend that Section 483 does not act as a safe harbor for gift tax purposes, and that a taxpayer utilizing Section 483 will incur a gift tax if the AFR exceeds the Section 483 safe harbor. The reasoning of this group, in a nutshell, is that Section 483 addresses only the characterization of payments as income or principal under an installment sale, NOT valuation of the installment obligation for gift tax purposes. A concurring opinion in the *Krabbenhoft* case, however, noted the anomalies of the decision to apply Section 483 only for income tax purposes:

> "Looking at section 483 in isolation and ignoring subsequent litigation, it is possible to conclude the "safe harbor" provision is applicable only to the income tax. In reaching this technical conclusion, one must accept the proposition that Congress either intended, or else simply failed to consider, the possible "gift tax traps" that would be created any time market rates rose above six percent." *Krabbenhoft*, at 534 (Henley, J., concurring).

A ray of hope, however, was also indicated in Judge Henley's opinion, which noted that, like *Ballard*, the *Krabbenhoft*[123] transaction occurred before the enactment of Sections 1274 and 7872:

> "Unfortunately, Congress did not get around to dealing with the problem until the 1983-1984 term when it created a uniform market-based system of interest rates. Through Sections 1271-1274, Congress enacted a market rate system for different types of loans that is updated periodically through Revenue Procedures. As government's counsel confirmed at oral argument, sections such as 483 and 7872 (low interest or no interest loans) now govern the *gift and income* tax treatment of most loans." Emphasis in original. *Id.* [124]

[119] *See* a subsequent case in the Tax Court, *Estate of H.A. True Jr., et al. v. Com'r*, TC Memo 2001-167, at 1273, following *Frazee* for the proposition that Section 7872 can apply to deferred payment arrangements in intra-family sales.
[120] *See* General Counsel Memorandum (G.C.M.) 39,566.
[121] *Krabbenhoft v. Com'r*, 939 F.2d 529 (8th Cir. 1991).
[122] The 10th Circuit is aligned with this group of taxpayer nemeses, as well, having held that the prefatory language of Section 483 ("For purposes of this title…") does not preclude the IRS from valuing an installment sales contract using prevailing market rates, in *Schusterman v. United States*, 63 F.3d 986 (10th Cir. 1995).
[123] *Krabbenhoft v. Com'r*, 939 F.2d 529 (8th Cir. 1991)
[124] Judge Henley's assumption was not borne out in the *Frazee* case.

In opposition to the authorities who apply Section 483 only as an income tax safe harbor stands the Seventh Circuit, which, in *Ballard*, held that the qualifying introductory language of Section 483 mandates its application to both gift and income tax, and constitutes a safe harbor from all adverse tax consequences under Title 26 of the Unites States Code.[125]

The confusion in this area reached its glorious apex with the puzzling Tax Court holding in *Frazee v. Commissioner*, a case that, unlike *Ballard* and *Krabbenhoft*, involved a dispute occurring *after* the enactment of Section 7872. *Frazee* involved the installment sale of real property ripe for development by a mother to her three children. The interest rate for the note was 7%, compounded semiannually, which exceeds the Section 483(e) rate but was lower than the AFR at the time. The taxpayer argued that Section 483(e) applied to protect her from imputed income and gift tax liability.

For starters, the court disregarded contemporary proposed regulations that stated that Section 483 would govern for gift tax purposes.[126] After holding (correctly) that Section 483(e) (providing a 6 percent safe harbor) applied to the transaction for income tax purposes, the Court fudged its way around newly enacted Section 7872(f)(8), stating that "[t]he presence of Section 7872(f)(8) signaled Congress' belief that Section 7872 could properly be applicable to some seller financing. We are not here to judge the wisdom of Section 7872, but rather, to apply the provision as drafted."[127] In other words, since Section 483 applies only for income tax characterization purposes, Section 7872(f)(8) applies only to exclude 7872 as an income tax safe harbor when both sections otherwise apply. Some may fairly characterize this as circular reasoning.[128]

Although the taxpayer lost in *Frazee*, it could have been worse. What if the IRS had urged, and the Court had held, that i) Section 483(e) applies for income tax purposes but not gift tax purposes; therefore ii) Section 7872 does not apply for any purpose because Section 7872(f)(8) states that it shall not apply; and iii) in the absence of a controlling statute, the fair market approach of *Ballard v. Commissioner.*[129] This is certainly a logical progression.[130] Fortunately for taxpayers, since the enactment of Section 7872, the IRS has conceded this point in *Frazee* and subsequent private letter rulings. In *Frazee*, the Court acknowledged the IRS concession that Section 7872 applied for gift tax purposes rather than valuing the note under a market rate approach: "We find it anomalous that respondent urges as her primary position the application of Section 7872, which

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[125] *Ballard v. Com'r*, 854 F.2d 185 (7th Cir. 1988).
[126] Dismissing proposed regulations as "no more than a litigation position", *Frazee* at 582.
[127] *Frazee* at 588.
[128] *See*, e.g., Courtney N. Stillman, *Choosing Interest Rates for Family Transactions to Avoid a Gift as Well as Imputed Income*, 83 J. TAX'N 155 (1995).
[129] 20 T.C. 204 (1953).
[130] This is similar to the reasoning employed by the Tenth Circuit in *Schusterman*, which involved a transaction prior to the enactment of Section 7872. In Schusterman, the court applied fair market value analysis for gift tax purposes to promissory notes issued by related irrevocable trusts for family stock. The court held that Section 483, although it applies to all of Title 26, only applies to re-characterize income and principal payments when below-market interest rates are charged – it is not a valuation provision applicable to the gift.

is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept."[131]

Relatively recent PLRs confirm the IRS position that Section 7872 will apply to the gift tax valuation of notes issued in intra-family sales transactions, regardless of the application of Sections 1274 or 483 to the transaction for income tax purposes.

- Private Letter Ruling 9535026 involved an installment sale of assets to a grantor trust in return for a note that paid interest annually at the Section 7872 rate, with a balloon payment of principal at the end of 20 years. The ruling summarizes the provisions of Section 7872 and discusses the *Frazee* case (which it summarizes as concluding that Section 7872 is not limited to loans of cash but is broadly interpreted to include any extension of credit). The ruling observes that the stated interest rate on the notes in question equals the Section 7872 rate. "Thus, we conclude that, if the fair market value of the stock transferred to the [trust] equals the principal amount of the note, the sale of stock to the [trust] will not result in a gift subject to gift tax. This ruling is conditioned on satisfaction of both of the following assumptions: (i) No facts are presented that would indicate that the notes will not be paid according to their terms; and (ii) the [trust's] ability to pay the notes is not otherwise in doubt."
- Private Letter Ruling 9408018 addressed whether the redemption of a mother's stock from a corporation, where her son was the remaining shareholder, constituted a gift. The note's interest rate equaled the greater of (i) 120% of the applicable federal mid-term rate, or (ii) the rate sufficient to provide the note with "adequate stated interest" under Section 1274(c)(2) (which is tied to the applicable federal rate). The ruling employed reasoning similar Ltr. Rul. 9535026, and concluded that because the interest rate on the note will be at least equal to the applicable federal rate for the month during which the note is executed, the fair market value of the note for federal gift tax purposes is the face value of the note. (That ruling similarly was conditioned on (i) there being no indication that the note would not be paid according to its terms and (ii) the corporation's ability to pay the notes is not otherwise in doubt.)

### *iv.* **The Point Being**

The bottom line is that this issue will remain submerged so long as the AFR remains around six percent, unless Congress intervenes.[132] When the AFR climbs above six percent, in intra-family land sales transactions, careful planners will apply the AFR unless gift taxes are not an issue. Aggressive planners outside of the 8th and 10th circuits may always choose to use the 6 percent safe harbor, relying on *Ballard,* common sense and fairness.

[131] 98 T.C. at 590.

[132] *See* Stephen J. Wolma, *Ambushed in a Safe Harbor*, 33 Val. U.L. Rev. 309 (1998), advocating Congressional action to resolve the conflict, short of Supreme Court intervention.

In intra-family sales transactions involving sales of personal use property (i.e., not land held for investment), at least under the Section 7872 proposed regulations, Section 483 is not applicable and Section 7872 should be used. The penalty for using the 7872 safe harbor in that case, however, is not burdensome, as the Section 1274 or 483 AFR (permitting the lowest of the prior three months' AFRs) is usually not substantially better than the Section 7872 AFR.

b. **Consequences of Using Inadequate Stated Interest: Imputed Interest or OID**

If either of Sections 483 or 1274 apply, and the applicable safe harbor interest rate is not utilized (the note does not call for qualified stated interest), interest will be imputed under Section 483 as "imputed interest" or under Section 1274 as "OID" (Original Interest Discount). Both are calculated in the same manner. However, they differ as to the timing of recognition of unstated interest.

*i.* **Timing**

When Section 1274 applies, OID is determined on a daily basis and is income to the seller and deductible by the buyer (unless the buyer is an individual and the interest is personal interest) without regard to the taxpayer's use of the accrual or cash method. The practical effect when OID is imputed is that OID will be allocated daily, thus thwarting the tax deferral effects of the delayed interest payments. By contrast, in the limited situations in which Section 483 still applies, the taxpayer's accounting method (i.e., cash or accrual) controls the timing for reporting unstated interest; interest is not included or deducted until a payment is made or due.

*ii.* **Amount: Computing OID**[133]

OID is present only to the extent a debt instrument's *stated redemption price at maturity* exceeds its *issue price.*[134] A debt instrument's *stated redemption price at maturity* is the sum of all payments provided by it, excluding qualified stated interest payments. For this purpose, *qualified stated interes*t is interest called for in the debt instrument that is unconditionally payable in cash or property (other than the issuer's debt instruments) at least annually at a single rate.[135]

Under Section 1274(a), the issue price of a debt instrument with adequate stated interest is its *stated principal amount* (i.e., the aggregate amount of all payments, other than stated interest, due under the instrument).[136] A debt instrument has *adequate stated interest* if it has a single stated interest rate, paid or compounded at least annually, that is equal to or greater than the appropriate test rate.[137] A debt instrument's *stated redemption price at maturity* may differ from its *stated principal amount* (causing OID to be present) because the former excludes only

[133] *See* PPC's Tax and Financial Planning Library, Dispositions of Real Estate, § 708 Installment Sales with OID or Unstated Interest.
[134] Int.Rev. Code § 1273(a)(1).
[135] Treas. Reg. §§ 1.1273-1(b) and (c).
[136] Treas. Reg. § 1.1274-2(b)(1).
[137] Treas. Reg. § 1.1274-2(c)(1).

qualified stated interest (as defined previously), while the latter excludes all interest provided for in the debt instrument. If a debt instrument to which Section 1274 applies does not have adequate stated interest, its issue price is the sum of the present values of all payments, including interest, due under the instrument (i.e., the *imputed principal amount*), determined using a discount rate equal to the appropriate test rate (which generally is 100% of the AFR).[138] Issue price for Section 1274(a) can also be defined as the lesser of the debt instrument's stated principal amount or its imputed principal amount.

c. **Income Tax Implications for Seller**

The following summaries assume a qualifying rate has been utilized in the installment sale.

*i.* **Recognition of Gain or Loss**

An installment sale is a disposition of property in which one or more payments are to be received after the year of the disposition.[139] Under Section 453(a), "income from an installment sale" is usually reported by "the installment method." With installment method, gross profit is determined by subtracting the seller's adjusted basis from the selling price. The gross profit is then divided by the selling price (less any "qualifying indebtedness" assumed or taken subject to by the buyer) to arrive at the "gross profit ratio."[140] Each payment of principal received by the seller is then multiplied by the gross profit ratio to determine the amount of each payment allocable to the gain and to nontaxable return of basis. [141]

> For example, if property with an adjusted basis of $30 is sold for $50, payable $10 at the closing and $10 annually for four years thereafter, with interest at an adequate rate on the deferred payments, the gross profit is $20 (contract price of $50 less adjusted basis of $30), resulting in a gross profit ratio of 40 percent ($20/$50). Thus, the seller has gain for the year of sale of $4 (40 percent of $10), and 40 percent of each later installment will be similarly includable in income when the installment is collected.[142] If the selling price is less than the seller's basis, a loss would be realized, but would most likely be disallowed under Section 267(a) because the purchaser would likely be a member of the seller's family to whom Section 267(b)(1) would apply, or a trust created by the grantor to which Section 267(b)(4) would apply.

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138 Int.Rev. Code §§ 1274(a) and (b); Treas. Reg. § 1.1274-2(c)(1).
139 Int.Rev. Code § 453(b)(1).
140 Temp. Reg. § 15A.453-1(b)(2)(1) through (iii).
141 Temp. Reg. § 15A.453-1(b)(2)(i).
142 *See* Bittker & Lokken, ¶106.1.1.

### *ii.* Disposition of Installment Note

#### (a) By Seller

A potential tax issue of which practitioners should be aware is caused when the selling family member disposes of an installment obligation. In that case the seller will be required to recognize all or part of the deferred gain if the installment obligation "is satisfied at other than its face value or distributed, sold, or otherwise disposed of" before the buyer completes the payments.[143]

(i) **Gift**. Giving an installment note back to the obligor is also a disposition, and giving an installment obligation to a related party recognizes the entire unpaid principal balance on the note at the time of the gift.[144]

(ii) **Partial Forgiveness**. Often a related party seller will forgive installment payments as they come due. In such case the donor/seller will be taxed on both the interest and gain portions of the forgiven installment, even though no cash is received. The forgiven gains are a taxed as a partial disposition of the obligation under Section 453B(f), and the donor will recognize the previously untaxed gain portion of the forgiven installment.

**EXAMPLE**:[145] Parent sells an asset to Child for $100,000. Parent's adjusted basis at the time of the sale is $20,000. Child gives Parent an installment note amortized by seven $20,000 annual payments and an eighth payment of $5,640, each payment including interest at the then-appropriate rate of 10 percent. Parent forgives the first installment and Parent consents to gift split. They intend to forgive each subsequent installment in the same manner. The IRS does not successfully challenge the transaction. Child's payments amortize the installment debt as follows:

| Year | Payment | Principal | Interest |
|---|---|---|---|
| 1 | $20,000 | $10,000 | $10,000 |
| 2 | 20,000 | 11,000 | 9,000 |
| 3 | 20,000 | 12,100 | 7,900 |
| 4 | 20,000 | 13,310 | 6,690 |
| 5 | 20,000 | 14,640 | 5,360 |
| 6 | 20,000 | 16,106 | 3,894 |
| 7 | 20,000 | 17,716 | 2,284 |
| 8 | 5,640 | 5,128 | 512 |

When Parent forgives the first $20,000 installment, Parent still must report $10,000 of interest income and $8,000 of long-term capital

[143] Int.Rev. Code § 453B(a).
[144] Int.Rev. Code § 453B(f).
[145] *See* Zaritzky & Aucutt, ¶ 12.02[4][a].

gain (the capital gain on the sale was $80,000 of the total $100,000 sales price, so 80 percent of each principal payment is a capital gain). Assuming that Parent is in the 35 percent marginal income tax bracket, Parent must pay $4,700 of income tax in the first year, even though Parent receives no cash (35 percent × $10,000 interest) + (15 percent × $8,000 capital gain).

(iii) **Death**. A bequest of an installment obligation does NOT trigger gain,[146] but the income is IRD -- the recipient of the obligation recognizes gain on the future payments to the extent the seller would have recognized it.[147] A bequest of an installment note to the obligor cancels the note (because a merger of interest has occurred) and accelerates the incidence of taxable IRD,[148] causing the decedent's estate to recognize the difference between the face amount and the decedent's basis in the obligation.[149] Such a bequest to an unrelated party, however, will cause the estate only to recognize the difference between the note's *fair market value* and the decedent's basis immediately before death, without regard to the actual outstanding balance.

(b) **Sale by Buyer[150]**

Under Section 453(e), the related buyer's sale of the purchased asset within two years of the date of the purchase is treated as a disposition by the original seller of the obligation.[151] Thus, an intra-family installment sale imposes a risk on the seller that the buyer will take some action that causes the seller's tax on the deferred gain to be accelerated.

EXAMPLE:[152] Parent sells a building to Child for $100,000. Parent's adjusted basis at the time of the sale is $20,000. Child gives Parent an installment note amortized by seven $20,000 annual payments and an eighth payment of $5,640, each payment including interest at the then-appropriate rate of 10 percent. One year (and one payment) after buying the building, Child resells it for $125,000. Parent is deemed to have received a complete payment of Child's installment note and must recognize the previously unrecognized $70,000 gain on the sale ($80,000 total gain on the sale less $10,000 gain recognized on the first installment payment). Assuming that Parent is in the 15 percent capital gains tax bracket, this produces a $10,500 capital gains tax (15% × $70,000 = $10,500).

- NOTE: A related buyer need not *resell* the purchased assets to create a problem for the seller. If the buyer's "disposition" is something other than a sale or exchange, the amount the seller is deemed to have received is

[146] Int.Rev. Code § 453B(c).
[147] Int.Rev. Code §§ 691(a)(4), 691(a)(5).
[148] Int.Rev. Code § 691(a)(5).
[149] Int.Rev. Code §§ 691(a)(5)(A)(iii), 691(a)(5)(B).
[150] *See* Zaritzky & Aucutt, ¶ 12.02[2].
[151] For this purpose, a related buyer includes the seller's spouse, child, grandchild, or parent, or a related trust, estate, partnership, or corporation. The seller's brother, sister, stepbrother, stepsister, aunt, uncle, or relative by marriage (other than the seller's spouse) is not a related party. Int.Rev. Code § 453(f)(1).
[152] *See* Zaritzky & Aucutt, ¶ 12.02[2].

the fair market value of the asset at the time of the second disposition.[153] Certain transactions, including the transmission of the asset at death, are not acceleration events under this rule, but gifts, notably, are dispositions.[154]

## 2. Installment Sale To Grantor Trust

### a. Description

The traditional disadvantage of an installment sale is that the donor has to recognize a substantial income tax gain as the installment payments are made. If the sale is made to a trust that is treated as a grantor trust for income tax purposes, but which will not be included in the settlor's estate for federal estate tax purposes, the estate freezing advantage can be achieved without the income tax costs usually associated with a sale.

Briefly, the steps of planning an installment sale to a grantor trust are as follows:

#### *i.* Create and "Seed" Grantor Trust

The individual should create a trust that is treated as a grantor trust for federal income tax purposes (meaning that the grantor is the owner of the trust for income tax purposes). The trust will be structured as a grantor trust for income tax purposes, but will be structured so that the grantor is not deemed to own the trust for estate tax purposes. This type of trust (which is treated as owned by the grantor for income but not estate tax purposes) is sometimes called a "defective trust."[155]

The grantor trust should be "seeded" with meaningful assets prior to a sale. (For example, the trust should hold approximately 10% in value of the eventual trust assets after a purchase occurs in step 2. In Letter Ruling 9535026, the IRS required the applicants to contribute trust equity of at least 10 percent of the installment purchase price.) As an example, if a $900,000 asset will be sold to the trust, the settlor might make a gift of $100,000 to the trust. After the trust purchases the asset, it would own assets of $1,000,000, and it would have a net worth of $100,000, or 10% of the total trust assets.[156]

There is lore that the value of equity inside the grantor trust must be 10% of the total value in order for the sale to be respected. In PLR 9535026, the IRS insisted on a 10% floor. Several speakers said that is not required, and some respected national speakers said that the equity amount could be as low as 1%--depending on the situation. One speaker (who considers himself a conservative planner) has used less than 10% sometimes, and on occasions he is concerned whether 10% is enough. The legal issue is whether there is debt or equity. (For

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[153] Int.Rev. Code § 453(e)(4).
[154] Int.Rev. Code § 453(e)(6).
[155] To assure that the trust is treated as wholly-owned by the grantor for income tax purposes, the most conservative approach is not to use Crummey withdrawal powers in the trust.
[156] The seed money can be accomplished either through gifts to the trust, or through transfers to the trust from other vehicles, such as a GRAT.

example, if it is debt, it is permissible to use the AFR as the interest rate.) The issue is whether there is comfort that the "debt" will be repaid.

*McDermott v. Commissioner*[157] involved a 19.6 to 1 debt equity ratio (which translates to a 5.6% equity amount). The IRS acquiesced in *McDermott*. One attorney uses that as a base point – he never uses less than 5.6% seeding. On the other hand, there is a published ruling involving a 20% contribution, and the IRS ruled it was debt. (That was not a sale to grantor trust situation.)

If the 10% seeding is based on analogy to Section 2701(a)(4), the initial seeding gift should be 11.1% of the amount of the later sale to the trust (if values remain constant.) If the grantor transfers $11.10 to the trust, and later sells an asset for a $100.00 note, the "$11.10 "seeding" would be 10% of the total $111.10 assets in the trust following the sale. That means there would be a 9:1 debt equity ratio.

In determining whether the note represents debt or equity, one must consider a variety of factors, including the nature (and volatility) of assets in the trust, and the risk profile of the clients. If there is experience of assets actually increasing in value after sales to the trust and payments actually being made, when the next grantor trust sale is considered, the grantor would seem to have good reason to be more comfortable using a lower equity cushion.

Some commentators suggest that seeding should not be required as long as the taxpayer can demonstrate that the purchaser will have access to the necessary funds to meet its obligations as they become due.[158] Even those authors, however, observe that the Section 2036 issue is an intensely factual one, and that "only those who are willing to take substantial risks should use a trust with no other significant assets."[159]

(a) **Beneficiary Guarantees = Gift?**

To protect against the note being characterized as equity rather than debt, sometimes a beneficiary will guarantee the note (regardless of whether a "seed" gift is made). The issue this raises is whether such a guarantee will constitute a taxable gift from the beneficiary to the trust, as the IRS has asserted in the past. Of particular concern is PLR 9113009, which the IRS withdrew in PLR 9409018 without any comment as to the gift tax provisions of the previous ruling. In this ruling, a father guaranteed debts of corporations in which his children were shareholders. The IRS found that these guarantees were gifts to those children, citing an example under Treas. Reg. section 25.2511-1(h)(1) for the proposition that a transfer to a corporation is a gift from the donor to the corporation's shareholders. The IRS may argue, at least in the absence of reasonable guarantee fees, that the guarantee by the beneficiaries will effectively permit the gratuitous use of the beneficiaries' credit for the benefit of the trust.

[157] 13 T.C. 468 (1949), *acq*. 1950-1 C.B. 3
[158] Hesch & Manning, 34 Univ. Miami Inst. Est. Pl., *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, ¶ 1601.1 (2000)(hereinafter "Hesch and Manning 2000").
[159] *Id*.

If the argument by the IRS is successful, it will clearly cause gift tax problems for the beneficiary/guarantors, as well as possible estate, generation-skipping, and income tax problems. In all probability, if any guarantee results in a taxable gift, it will be a future interest gift that will not be offset by the annual exclusion, at least in the absence of withdrawal rights and notices, and will thus be a taxable gift to the full extent of the value of the guarantee.[160] The timing and amount of the gift, if any, is unclear. Probably the closest commercial analogy is a bank's charge for a letter of credit. Generally, the bank makes an annual or more frequent charge for such a letter. By analogy, there will be an annual gift, probably in the range of one to two percent of the amount guaranteed, so long as the guarantee is outstanding. However, it may also be argued that a much larger, one-time taxable gift will occur at the inception of the guarantee, especially if the loan precludes prepayment.[161] The final possibility is that no gift will occur until a beneficiary actually has to make a payment under the guarantee. In this event, the measure of the gift will presumably be the amount of the payment under the guarantee. [162]

It is by no means a given that a guarantee by a beneficiary is a gift. Instead, the clear weight of authority seems to support the absence of any gift by the beneficiaries to the trust, at least (1) where the upside potential from the beneficial interest of the guarantor-beneficiary is sufficient to warrant that guarantor-beneficiary taking the downside risk posed by the guarantee, (2) where the guarantee is a bona fide obligation of the beneficiary making the guarantee, and (3) where the beneficiary has sufficient net worth to make good on the guarantee in the event of a default by the trust.[163]

*ii.* **Sale for Installment Note; Appropriate Interest Rate**

The individual will sell property to the grantor trust in return for an installment note for the full value of the property (taking into account appropriate valuation discounts). The note is typically secured by the sold asset, but it is a full recourse note. The note is often structured to provide interest only annual payments with a balloon payment at the end of the note term. The interest is typically structured to be equal to the Section 7872 rate (which is even lower than the Section 7520 rate which is used for structuring GRATs). Often a 9-year note will be used so that the federal mid-term rate would apply. For June, 2006 (when the Section 7520 rate is 6.0%), the annual short-term (0-3 years) rate is 4.99%, the annual mid-term (over 3, up to 9 years) rate is 5.06%, and the long-term (over 9 years) rate is 5.32%. Typically, the note would permit prepayment of the note at any time. The note should not be shorter than the seller's life expectancy.

Some planners have suggested taking the position that the lowest AFR in the month of a sale or the prior two months can be used in a sale to defective trust

[160] *See* Int.Rev. Code § 2503(b).
[161] *See* Rev. Rul. 94-25, 1994-1 C.B. 191.
[162] *See Bradford v. Commissioner*, 34 T.C. 1059 (1960).
[163] *See* Hatcher and Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. of Taxation 152 (March, 2000) (hereafter, "Hatcher and Manigault"), which sets forth a detailed rebuttal of a taxable gift being imputed by reason of a bona fide, pro rata guarantee by a beneficiary of a defective grantor trust.

situation, relying on Section 1274(d). Section 1274(d) says that for any sale or exchange, the lowest AFR for the month of the sale or the prior two months can be used. However, relying on Section 1274(d) is problematic for a sale to a defective trust--because such a transaction, which is a "non-event" for income tax purposes, may not constitute a "sale or exchange" for purposes of Section 1274(d). The apparently unqualified incorporation of Section 1274(d) in Section 7872(f)(2) arguably gives some credibility to this technique. However, relying on a feature that depends on the existence of a "sale" as that word is used in Section 1274(d)(2) [in the income tax subtitle] in the context of a transaction that is intended not to be a "sale" for income tax purposes seems unwise.

Most planners use the applicable federal rate, under the auspices of Section 7872, as the interest rate on notes for intra-family installment sales. Section 7872 addresses the gift tax effects of "below-market" loans, and Section 7872(f)(1) defines "present value" with reference to the "applicable Federal rate." Using Section 7872 rates would seem to be supported by the position of the IRS in a Tax Court case and in several private rulings.[164]

*iii.* **Operation During Term of Note**

Hopefully the trust will have sufficient cash to make the interest payments on the note. If not, the trust could distribute in-kind assets of the trust in satisfaction of the interest payments. Payment of the interest, whether in cash or with appreciated property, should not generate any gain to the trust or to the grantor, because the grantor is deemed to be the owner of the trust for income tax purposes in any event.

Because the trust is a grantor trust, the grantor will owe income taxes with respect to income earned by the trust. Payment of those income taxes by the grantor is not an additional gift to the trust.[165]

*iv.* **Pay Note During Seller's Lifetime**

Plan to repay the note entirely during the seller's lifetime. Income tax effects may result if the note has not been paid fully by the time of the seller's death.

The installment note could be structured as a self-canceling installment note ("SCIN") that is payable until the expiration of the stated term of the note or until the maker's death, whichever first occurs. See Section 3 below regarding SCINs.

b. **Basic Estate Tax Effects**

The sale to grantor trust strategy, if implemented correctly, should have the following estate tax effects: 1) Note Includible In Estate; 2) Assets Sold to Trust Excluded from Estate; and 3) Grantor's Payment of Income Taxes Decreases Estate.

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[164] *See* Section G.a.iii., infra, *Frazee* and Its Antecedents.
[165] Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

### c. **Basic Gift Tax Effects**

The grantor should "seed" the trust with approximately 10% of the overall value to be transferred to the trust by a combination of gift and sale. This could be accomplished with an outright gift when the grantor trust is created. Alternatively, the grantor trust could receive the remaining amount in a GRAT at the termination of the GRAT to provide seeding for a further installment sale.

The sale to the trust will not be treated as a gift (assuming the values are correct, and assuming that there is sufficient equity in the trust to support valuing the note at its full face value.) There is no clear authority for using a valuation adjustment clause as exists under the regulations for GRATs.

### d. **Basic Income Tax Effects**

The initial sale to the trust does not cause immediate gain recognition, because the grantor is treated as the owner of the trust for income tax purposes.[166]

Because the grantor is treated as the owner of the trust, interest payments from the trust to the grantor should also be a non-event for income tax purposes.

In order to avoid gain recognition on a sale to a grantor trust, the grantor must be treated as wholly owning the assets of the trust. This may be endangered if the trust contains a *Crummey* withdrawal clause. The IRS generally treats the holder of a *Crummey* power as the owner of the portion of the trust represented by the withdrawal power under Section 678(a)(1) while the power exists and under Section 678(a)(2) after the power lapses if the power holder is also a beneficiary of the trust.[167]

#### *i.* **Grantor's Liability for Ongoing Income Taxes of Trust**

The grantor will be liable for ongoing income taxes for the trust income. This can further reduce the grantor's estate for estate tax purposes and allow the trust to grow faster.

#### *ii.* **Seller Dies Before Note Paid in Full**

If the seller dies before the note is paid off, the IRS may argue that gain recognition is triggered at the client's death. The better view would seem to be that gain recognition is deferred under Section 453 until the obligation is satisfied after the seller's death. The recipient of installment payments would treat the payments as income in respect of decedent. Presumably, the trustee would increase the trust's basis in a portion of the business interest to reflect any gain actually recognized. The income tax effect on the trust if the grantor dies before the note is paid in full has been hotly debated among commentators.[168]

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[166] Treas. Reg. §1.1001-2(c) Ex.5: Rev. Rul. 85-13, 1985-1 C.B. 184.
[167] *See* Ltr. Ruls. 200011058, 200011054-056, 199942037 & 199935046.
[168] Compare Dunn & Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, 95 J. Tax'n (July 2001) *with* Manning & Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt. Est., Gift & Tr. J. 3 (1999);

*iii.* **Gift Tax Basis Adjustment**

If a donor makes a gift to the grantor trust in order to "seed" an installment sale, and if the donor has to pay gift tax with respect to the initial gift, can the trust claim a basis adjustment under Section 1015(d) for the gift tax paid? There is no definitive authority as to whether the basis adjustment is authorized, but there would seem to be a good-faith argument that the gift-tax paid basis adjustment should be permitted even though the gift was to a grantor trust.

e. **Generation-Skipping Transfer Tax Effects**

Once the trust has been seeded, and GST exemption has been allocated to cover that gift, no further GST exemption need be allocated to the trust with respect to the sale (assuming that it is for full value).

f. **Advantages of Sale to Grantor Trust Technique**

*i.* **No Survival Requirement**

The estate freeze is completed without the requirement for survival for a designated period.

*ii.* **Low Interest Rate**

The interest rate on the note can probably be used on the Section 7872 rate, which is significantly lower than the §7520 rate which must be used for structuring the annuity payments from GRATs.

There is, at least arguably, some question as to whether a deferred payment sale should be subject to Section 7872, since Section 7872(f)(8) provides that the section in general does not apply to any loan to which Sections 483 or 1274 applies. However, in *Frazee v. Com'r*[169], the Tax Court accepted the IRS's contention that Sections 483 and 1274 are not valuation provisions, and, therefore, that Section 7872 must control for gift tax purposes.

*iii.* **GST Exempt**

The sale can be made to a GST exempt trust, or a trust for grandchildren, so that all future appreciation following the sale will be in an exempt trust with no need for further GST exemption allocation. For a GRAT, no GST exemption can be allocated during the period of the retained term (because it is an ETIP, Section 2642(f)(3)).

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Hatcher & Manigault, at 161-64; Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. Tax'n 149 (Sept. 2002).

[169] 98 T.C. 554 (1992). *See* Section G.a.iii, infra, *Frazee* and its Antecedents.

*iv.* **Interest-Only Balloon Note**

The installment note can be structured as an interest only-balloon note. With a GRAT, the annuity payments cannot increase more than 120% in any year, requiring that substantial annuity payments be paid in each year.

*v.* **Income Tax Advantages**

The estate freeze is completed without having to recognize any income tax on the sale of the assets as long as the note is repaid during the seller's lifetime. In addition, the interest payments will not have to be reported by the seller as income.

g. **Risks**

*i.* **Treatment of Note as Retained Equity Interest Causing Estate Inclusion of Transferred Asset**

Under extreme circumstances, it is possible that the IRS may take the position that the note is treated as a retained equity interest in the trust rather than as a mere note from the trust.[170] If so, this would raise potential questions of whether some of the trust assets should be included in the grantor's estate under §2036 and §2702. It would seem that §2036 (which generally causes estate inclusion where the grantor has made a *gift* of an asset and retained the right to the income from that asset) should not apply to the extent that the grantor has sold (rather than gifted) the asset for full market value.[171]

One letter ruling concluded that Section 2036 did apply to property sold to a grantor trust in return for a note, based on the facts in that situation. Letter Ruling 9251004 (transfer of $5.0 million of stock to trust in return for $1.5 million note in "sale/gift" transaction; ruling held that Section 2036 applies to retained right to payments under note, reasoning that note payments would constitute a major share, if not all, of the trust income, thus causing inclusion of trust property in estate).[172]

One commentator has suggested that there is a significant risk of Section 2036(a)(1) being argued by the IRS if "the annual trust income does not exceed the accrued annual interest on the note."[173] Much of the risk of estate inclusion

[170] There is, in any intra-family transaction involving a debt obligation, the danger that the IRS will disregard the promissory note and re-characterize the debt as equity. See Section B of this outline.

[171] *See* Letter Rulings 9436006 (stock contributed to grantor trust and other stock sold to trust for 25-year note; ruling holds § 2702 does not apply); 9535026 (property sold to grantor trust for note, interest-only AFR rate for 20 years with a balloon payment at end of 20 years; held that the note is treated as debt and "debt instrument is not a retained interest" for purposes of § 2702; specifically refrained from ruling on § 2036 issue).

[172] For a listing of cases that have addressed the application of § 2036 in the context of private annuity transactions where are the grantor is retaining the right to receive substantial payments from a trust, *see* Hesch & Manning 2000, ¶ 1601.1, n. 55.

[173] Covey, *Practical Drafting* 4365-4370, at 4367.

seems tied to the failure to have sufficient "seeding" of equity in the trust prior to the sale.

### *ii.* Risks of Thin Capitalization

One commentator summarizes the possible risks of thin capitalization as follows--"includibility of the gross estate under Section 2036, a gift upon the cessation of Section 2036 exposure, applicability of Section 2702 to such a gift, the creation of a second class of equity in the underlying property with possible consequences under Section 2701 and possible loss of eligibility of the trust to be an S Corporation, continued estate tax exposure for three years after cessation of Section 2036 exposure under Section 2035, and inability to allocate GST exemption during the ensuing ETIP. The Section 2036 problem may go away as the principal on the note is paid down, or as the value of the purchased property (the equity) appreciates, but the ETIP problem would remain."[174]

The IRS has questioned the validity of a sale of limited partnership interests to a grantor trust in the *Karmazin* case, where the IRS challenged installment notes received in transactions involving 10% "seed" gifts to grantor trusts. According to the IRS, the installment notes represented equity, not debt, because of the thin capitalization, and this reclassification allegedly resulted in substantial taxable gifts under either or both of Sections 2701 and 2702.[175] As part of an overall settlement before any trial, however, this equity versus debt issue was conceded by the Service. Despite this scare, there now appears to be no reason to believe at this time that the IRS is reevaluating its prior informal position concerning 10% "seed" gifts.

### *iii.* Potential Gain Recognition if Seller Dies Before Note Paid

There is potential gain recognition if the seller dies before all of the note payments are made. The IRS may argue that the gain is accelerated to the moment of death. It would seem more likely that the gain should not be recognized until payments are actually made on the note. Credible arguments can be made for no income realization either during or after the grantor's death, as discussed in Section X of this outline.

### *iv.* Valuation Risk

If the IRS determines that the transferred assets exceed the note amount, the difference is a gift. There is no regulatory safe harbor of a "savings clause" as there is with a GRAT. One way that might reduce the gift tax exposure risk is to use a defined value clause—defining the amount transferred by way of a fractional allocation between an (1) irrevocable trust and (2) the spouse (or a QTIP Trust or a GRAT). The fractional allocation would be analogous to a typical marital deduction formula clause, based on the values as finally determined for federal

[174] Aucutt, *Installment Sales to Grantor Trusts*, ALI-ABA Planning Techniques for Large Estates 949, 980 (April 2005).
[175] *See Karmazin v. Commissioner*, T.C. Docket No. 2127-03.

gift tax purposes, with any value exceeding the note amount to be allocated to the spouse (or a QTIP Trust or a GRAT).

*v.* **Volatility Risk**

If the asset that is sold to the trust declines in value, the trust still owes the full amount of the note to the grantor. Thus, any equity that had been gifted to the trust prior to the sale could be returned to the donor or included in the donor's estate. Furthermore, if beneficiaries or others give guaranties to provide the 10% "seeding," the guarantors will have to pay the guaranteed amount to the trust if the trust is otherwise unable to pay the note.

## 3. SCINs

### a. Introduction

Another potential disadvantage of a basic intra-family installment sale or sale to a grantor trust is the potential inclusion, in the seller's estate, of the unpaid obligation at its fair market value on the date of the seller's death. One way to avoid this problem is to use a self-canceling installment note (SCIN), a debt obligation containing a provision canceling the liability upon the death of the holder. If the holder dies prior to the expiration of the term of the SCIN, the automatic cancellation feature may operate to remove a significant amount of assets from what would otherwise be includible in the estate of the holder.

As discussed below, the SCIN transaction works best when the seller/client dies prior to, and "preferably" materially prior to, his or her actuarial life expectancy. The ideal candidate is someone in poor health, but whose death is not imminent, or someone with a very poor family health history. As with all sophisticated tax planning strategies, the SCIN is not for all clients or all situations, especially since clients' actual life expectancies are never truly known in advance.

There are also numerous issues concerning the technique which have not yet been fully resolved. In addition to the obvious mortality issue, there are questions as to what base rates should be used (the Section 7520 rate or the AFR?), what life expectancies should be used (the tables used under Section 7520, the tables used under Section 72, or the seller's actual life expectancy?), how the payments should be allocated for income tax purposes (what amounts are return of basis, interest, and gain?) and the effect of the cancellation of the note upon the seller's death for income tax purposes (is the cancellation a taxable event for the debtor?).

### b. Note Terms

*i.* **Interest Rate**

Although it is tempting to apply the below-market safe harbor of Section 7872 (and, arguably, Section 1274 (d)), there is an additional element at work with the SCIN that makes it advisable to structure the SCIN so that the value of the SCIN is at least equal to the value of the property sold.

For the value of the SCIN to equal the value of the property sold, the seller of the property must be compensated for the risk that the seller may die during the term of the note, and thus not receive the full purchase price. Since such a feature must be bargained for at arm's length to be respected, the seller must be compensated for the risk associated with the potential cancellation either by an increase in the purchase price or by a higher interest rate.[176] To calculate the premium, an advisor must determine what stream of payments are required, taking into consideration the possible death of the seller, to have the same present value as the principal amount of the promissory note.[177] There is not universal agreement on how payments under a SCIN are properly valued, for there is no clear answer concerning which mortality tables should be used and which discount rate should be applied to value the payments. Some commentators use the life expectancies in Table 90CM (Treas. Reg. § 20.2031-7(d)(7) and Aleph Volume (Pub. 1457)) and a rate equal to the greater of 120% of the mid-term AFR, assuming annual payments, as prescribed by Section 7520, or the AFR for the actual term of the note, as prescribed by Section 7872.[178] Others use the annuity tables (Treas. Reg. § 1.72-9, Table V) and the AFR as prescribed by Section 7872.[179] Additionally, the Service has indicated that an individual's actual life expectancy may be used (G.C.M. 39503, *supra*), and other commentators have recommended that the actual life expectancy be used.[180]

While an advisor could determine these payment streams and resulting rates manually, or by use of a computer program, some commentators recommend that an actuary be employed.[181]

Although the matter is by no means free from doubt, some commentators are persuaded by the well-reasoned approach of *Hesch and Manning*. The Section 7872 AFRs are, more likely than not, appropriate, and the examples used in regard to SCINs will generally use AFRs, not Section 7520 rates. Nonetheless, AFRs should not be used by the faint of heart. A conservative planner probably should use the higher of the Section 7520 rate or the AFR for the actual term of the note, as recommended by *Covey*. Clearly, many, if not most, practitioners are using the higher of the Section 7520 rate or the AFR for the actual term of the note, for the gift, and possibly the estate, tax risk of using a rate which is too low is simply too great.

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[176] *See* Banoff and Hartz, *Self-Canceling Installment Notes: New IRS Rules Expand Opportunities*, 65 J. Tax'n 146 (1986) (hereinafter, "Banoff and Hartz 1986").
[177] *See* Covey, et al. *Q&A Session I of the Twenty-Seventh Annual Institute on Estate Planning*, 27 U. Miami Inst. on Est. Plan. ¶216 (1993).
[178] *Id.*
[179] *See* Hesch and Manning 2000, ¶1601.3(B)(1) and (2).
[180] *See* Banoff and Hartz, *Sales of Property: Will Self-Canceling Installment Notes Make Private Annuities Obsolete?*, 59 Taxes 499, 515 (1981).
[181] *See* Covey, et al. *Q&A Session I of the Twenty-Seventh Annual Institute on Estate Planning*, 27 U. Miami Inst. on Est. Plan. ¶216 (1993), and Smith and Olsen, *Fractionalized Equity Valuation Planning: Preservation of Post-Mortem Valuation Discounts*, 34 U. Miami Inst. on Est. Plan. ¶ 1103.3(F)(2) (2000)

*ii.* **Term**

The term of the SCIN should not equal or exceed the individual's life expectancy, or the SCIN might be recharacterized as a private annuity. G.C.M. 39503, *supra*, Issue 1. Even this conclusion is not universally accepted.[182] As noted above, however, there is a difference of opinion as to how life expectancy is to be determined. Are the 90CM estate tax tables under Treas. Reg. section 20.2031-7(d)(7) and Aleph Volume (Pub. 1457), the income tax annuity tables under Treas. Reg. section 1.72-9, Table V, or the Seller's actual life expectancy to be used? While a conservative approach would be to structure the SCIN to have a term which is shorter than the shortest of all of these possible life expectancies, such a structure would materially detract from the primary advantage of the SCIN -- the likelihood that a would-be seller with health problems or a poor family health history will die before he or she is "supposed to." If the seller has a "terminal illness," however, the actuarial tables should not be used. *See* Treas. Reg. section 20.7520-3(b)(3), which may or may not apply (depending upon whether Section 7520 rates apply to SCINs). If Section 7520 applies for these purposes, "terminal illness" means that the individual has an "incurable illness or other deteriorating physical condition" which results in at least a 50% probability that he or she will die within one year.[183] If the person lives for 18 months or longer after the relevant valuation date, he will be presumed not to have been terminally ill at the time of the transaction, unless the existence of a terminal illness can be established by clear and convincing evidence.[184] Whether or not SCINs are technically subject to this regulation, it is probably wise not to use standard actuarial tables when a person is gravely ill.[185]
Also, as discussed above in the context of an installment sale to an IDGT, a SCIN term which is too long may raise debt/equity concerns, especially when the sale is to a trust with comparatively few other assets.

The mortality component of the SCIN increases as the term of the SCIN increases, for a greater risk premium must be added to the SCIN to compensate the seller for the higher probability that the seller will die prior to the expiration of the longer term.

*iii.* **Premium on Principal**

If the risk premium is not reflected in a higher interest rate, then it must be added to the sales price and reflected in a higher face amount of the SCIN. As discussed below, a principal risk premium should be treated as a capital gain to the seller and increase the basis of the property in the hands of the purchaser.

*iv.* **Comparison of Interest and Principal Premiums**

If a self-amortizing note with equal principal and interest payments is used, there should be no difference for estate tax purposes between choosing an interest risk

[182] *See* Hesch and Manning 2000, at ¶1601.3(A).
[183] Treas. Reg. § 1.7520-3(b)(3).
[184] Treas. Reg. § 1.7520-3(b)(3).
[185] *See* Hesch and Manning 2000, at ¶1601.3(c).

premium and a principal risk premium, as the annual payments under either structure would be the same. If, however, an interest-only SCIN or a level principal payment SCIN is used, then for estate tax purposes, the relative merits of choosing the principal premium or interest rate premium to compensate the seller for the risk of death occurring during the term of the SCIN should be analyzed, as the benefits depend upon the type of note used.

For income tax purposes, choosing to increase the principal balance of the purchase price will generally result in higher capital gains taxes and lower interest income being reported by the seller, with the buyer receiving a higher basis in the purchased asset and a lower current deduction, if any, for the payment of interest. Conversely, if the purchase price remains equal to the fair market value of the property sold and the interest rate is instead increased, then the seller will report more interest and less capital gains income. In turn, purchaser will take a lower cost basis in the acquired property, but may have a higher current deduction for the increased interest payments.[186]

c. **Tax Analysis**

*i.* **Income Tax Consequences to Seller**

**(a) Sale to Family Member or Non-Grantor Trust**

(i) **Availability of Installment Method**. A sale of property to a family member or a non-grantor trust in exchange for a properly structured SCIN is a taxable event and, unless the seller elects otherwise, should generally result in installment sale treatment for the seller.[187] Under the installment method, it is assumed that the seller will outlive the term of the SCIN, and the maximum principal amount to be received by the seller in the SCIN transaction, including any principal premium, is the "selling price."[188] The seller's adjusted basis is then subtracted from this selling price to determine the gross profit, if the selling price exceeds the basis.[189]

A portion of each payment will also consist of interest, which may be calculated under one of two methods, depending upon whether the SCIN is treated as a maximum selling price installment sale, or as a contingent payment installment sale.[190] By treating the payment stream as a maximum selling price installment sale, the interest paid will be front-loaded. In contrast, if the payment stream is treated as a contingent payment installment sale, the interest paid will be back-loaded.

[186] Hesch and Manning, *Family Deferred Payment Sales, Installment Sales, SCINs, Private Annuity Sales, OID and Other Enigmas*, 26 U. of Miami Inst. on Est. Plan. ¶310.3(B) (1992) (hereinafter "Hesch and Manning 1992").
[187] Temp. Reg. § 15A.453-1(c)(1).
[188] Temp. Reg. § 15A.453-1(c)(2)(i)(A).
[189] Temp. Reg. § 15A.453-1(b)(2)(v).
[190] Hesch and Manning 1992, at ¶310.3(B)(4).

(ii) **Death of Seller During the Term of the SCIN**. If the SCIN is cancelled by reason of the death of the seller during the note term, any deferred gain will be recognized as income. The primary question is whether the deferred gain is properly includible (a) on the deceased seller's final return, in which event the resulting income tax liability should be deductible as a Section 2053 claim against the estate for estate tax purposes, or (b) in the initial return of the deceased seller's estate as an item of income in respect of a decedent ("IRD") under Section 691.[191]

When the issue arose in *Estate of Frane*, the Tax Court agreed that gain should be recognized upon the death of the seller prior to the expiration of the term of the SCIN, but held that the gain was properly reportable by the seller on the seller's final return, not by the seller's estate.[192] The Tax Court held that the income tax consequences of the cancellation were governed by Section 453B(f), which had been enacted, in part, to overrule the outcome of *Miller v. Usury*,[193], so that the cancellation of a SCIN would be treated as a disposition.[194] Because the cancellation was in favor of a related party, the fair market value of the obligation would be no less than the face amount of the obligation.[195] Since the Tax Court held that the gain was properly reportable on the seller's final income tax return, it also held that the Seller's estate was not taxable under the IRD rules of Section 691(a).

The Eighth Circuit Court of Appeals overturned the Tax Court in favor of the Service's alternate position that the decedent's estate recognizes the deferred gain on its initial income tax return as an item of IRD.[196] In *Estate of Frane*, the Eighth Circuit held that the cancellation of a SCIN is not a "disposition" which is taxed to the seller under Section 453B pursuant to Section 453B(f), but is rather a "transmission" which is taxable as IRD to the estate under Section 691 pursuant to Section 453B(c). The Eighth Circuit based this decision on the language in Section 691(a)(5)(iii) that "cancellation occurring at the death of obligee shall be treated as a transfer by the estate, taxable under Section 691(a)(2)."[197] This holding is in accord with the IRS position in Rev. Rul. 86-72, 1986-1 C.B. 253.

The Eighth Circuit decision in *Frane* may not be the final word on the issue of whether the deferred gain is includible in income by the deceased seller on his final return or by the estate of the deceased

[191] *See* Banoff and Hartz 1986, at 150-51, and Hesch and Manning 1992, at ¶306.1(F).
[192] *Estate of Frane v. Commissioner*, 98 T.C. 341, 354 (1992).
[193] 160 F. Supp. 368 (W.D. La. 1958).
[194] Int.Rev. Code § 453B(f)(1).
[195] Int.Rev. Code § 453B(f)(2).
[196] *Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993).
[197] *Id.*, at 572.

seller on its initial return. A strong argument can be made that the gain should be recognized by the seller on his or her final income tax return in accordance with the Tax Court decision and Section 453B(f).[198]

**(b) Sale to Grantor Trust**

As in the case of a typical installment sale to a grantor trust, the trust's purchase of the seller's property in exchange for a SCIN should not be a taxable event, at least as long as the trust remains a grantor trust.

(i) **Cessation of Grantor Trust Status During Grantor's Lifetime.** If the grantor trust ceases to be a grantor trust during the grantor's lifetime, and if the SCIN is still outstanding at the time of such cessation, a taxable event is likely to be deemed to have occurred at the time the trust ceases to be a grantor trust.[199] Presumably, any gain will be based on the excess of the amount then due under the SCIN over the adjusted basis of the grantor trust's assets.

(ii) **Grantor's Death During Installment Note Term**. The grantor's death before the end of the term of the SCIN results in the cancellation of the remaining payments otherwise due under the SCIN. Because of the cancellation feature, and because the sale never took place for income tax purposes during the life of the seller, the deferred gain that would normally be recognized upon the death of the seller under *Frane* arguably should not be recognized by the seller or the seller's estate, although the matter is not free from doubt.[200]

*ii.* **Income Tax Consequences to Purchaser**

(a) **Sale to Family Member or Non-Grantor Trust**

(i) **Basis**. If the sale is to a family member or a non-grantor trust, the first income tax consideration for the buyer-debtor is the calculation of the basis in the property received. Unfortunately, the manner in which basis is determined is not completely settled. G.C.M. 39503 concludes that the buyer-debtor acquires a basis equal to the maximum purchase price of the property. This result would be symmetrical to the treatment of cancellation at death in favor of a related party as a disposition under Section 453B(f) and is arguably supported by what might be dicta in the Eighth Circuit's decision in *Frane*.[201] G.C.M. 39503, and the *Frane* appellate decision in, however,

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[198] *See* Hesch and Manning 2000, at ¶1601.3, and Warnick, 805 T.M., *Private Annuities*, at A-14.

[199] *See* Treas. Reg. § 1.1001-2(c), Example (5), *Madorin v. Commissioner*, Rev. Rul. 77-402, 1977-2 C.B. 222, and PLR 200010010.

[200] *See* Hesch and Manning 2000, at ¶1601.4. *See also* the discussion of what happens when a seller in a normal installment sale to a grantor trust dies before the installment note is satisfied in full.

[201] *See* Hesch and Manning 2000, at ¶1601.3(F) and *Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993), n.5.

both predate the final versions of Treas. Reg. sections 1.483-4 and 1.1275-4(c)(5), which provide that a purchaser only receives basis when payments are made on a contingent payment instrument, not when the contingent payment obligation is issued. Although it is not clear that a SCIN is a contingent payment instrument subject to these regulations, a conservative purchaser may choose to increase basis only to the extent that payments are made, especially because of the potential penalties under Sections 6662(e)(1)(A) and (h)(2) if the adjusted basis claimed exceeds 200% of the amount determined to be correct.[202]

(ii) **Interest Deduction**. The second income tax consideration for the purchaser is the amount and deductibility of interest. The amount of the interest component of each payment should be computed under one of the two methods discussed above in regard to the seller. As for the buyer's ability to deduct the interest, while G.C.M. 39503 states that "[in] the installment sale situation, …interest is fully deductible by the buyer", the purchaser will be subject to the typical limitations placed on the deductibility of interest, depending upon the nature of the assets purchased. Although the default classification of interest for an individual is non-deductible personal interest[203], interest payments under a SCIN, unless issued in regard to the purchase of a personal use asset other than a primary or secondary residence, should generally be deductible as investment interest under Section 163(h)(2)(B) (subject to the limitations of Section 163(d)), as qualified residence interest with respect to a primary or secondary residence under Sections 163(h)(2)(D) and (h)(3), as passive activity interest under Sections 163(h)(2)(C) and 469, or as business interest under Section 163(h)(2)(A).

(iii) **Cancellation of SCIN**. Finally, although the death of the seller during the term of the SCIN arguably may represent cancellation of indebtedness, resulting in a reduction of the buyer's basis under Section 108(e) (and possibly taxable income to the buyer to the extent that the cancellation of indebtedness exceeds basis), this result does not seem to comport with the intent of Section 108(e).[204]

(b) **Sale to Grantor Trust**

As in the case of a typical installment sale to a grantor trust, the trust's purchase of the seller's property in exchange for a SCIN should not be a taxable event, at least as long as the trust remains a grantor trust.

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[202] *See* Hesch and Manning 2000, at ¶1601.3(F), in which the authors contend that a SCIN should not be treated as a contingent payment obligation for these purposes.
[203] Int.Rev. Code §§ 163(h)(1) and (2).
[204] *Compare* Raby and Raby, *Self-Canceling Installment Notes and Private Annuities*, 2001 TNT 115-54 (2001), which takes the position that Code § 108(e) applies, *with* Hesch and Manning 2000, at ¶1601.3(F), and Hesch, *The SCINs Game Continues*, 2001 TNT 136-96 (2001), which make a persuasive argument that Code § 108(e) does not apply.

(i) **Cessation of Grantor Trust Status During Grantor's Lifetime**. If the trust ceases to be a grantor trust during the grantor's lifetime, if the SCIN is still outstanding at the time of such cessation, and if a taxable event is deemed to have occurred at the time the trust ceases to be a grantor trust, then the trust will take either a cost basis for the purchased property, which presumably will equal the outstanding balance under the SCIN at the time the trust ceases to be a grantor trust, or possibly will take a basis for such property equal to the payments under the SCIN, as provided under Treas. Reg. sections 1.483-4 and 1.1275-4(c)(5) for a contingent payment instrument.

(ii) **Grantor's Death During Installment Note Term**. The grantor's death before the end of the term of the SCIN results in the cancellation of the remaining payments otherwise due under the SCIN. As in the case of a typical installment sale to a grantor trust, the outcome is certainly not free from doubt, but because of the cancellation feature, and because the grantor trust would not be obligated to make any payments under the SCIN after the seller's death, the trust should take a basis under Section 1015(b), which would typically be a carryover basis as opposed to a cost basis.[205]

*iii.* **Gift Tax Considerations**

There are several gift tax considerations in regard to a SCIN transaction. These are substantially the same as those in regard to a typical installment sale to a grantor trust.

First, there is the normal valuation issue with respect to the assets sold in the transaction. Second, if the value of the SCIN received is found to be worth less than the value of the property sold (or not "substantially equal" to the value under the standard set forth in G.C.M. 39503), then the transaction will be treated as a part sale/part gift. The potential negative implications of such a bargain sale are very similar to those discussed above with respect to a typical installment sale to a grantor trust. Not only would a taxable gift result, but if the property is sold to a trust, the gift may even cause the assets in the trust to be ultimately includible in the grantor's gross estate, for estate tax purposes, at their date of death or alternate valuation date values, including any appreciation after the initial transfer of the assets to the trust.

If a trust is the purchaser in a SCIN transaction in which a principal premium approach is used, substantially greater "seed" funding may be required to insure that the SCIN will be regarded as bona fide debt. In all probability, the total trust assets, or access to assets (taking into account bona fide guarantees), should be at least 10% (or possibly 11.1%) more than the principal obligation under the SCIN, including the principal premium. Otherwise, the transfer to the trust may

[205] *See* Hesch and Manning 2000, at ¶1601.4.

be treated as an equity contribution, which almost inevitably would result in a significant taxable gift.[206]

### *iv.* Estate Tax Considerations

If the SCIN is properly structured, and if there are no other retained interests in the SCIN or in a purchasing trust which would result in inclusion, the seller's death prior to the expiration of the SCIN term should result in the inclusion in the seller's gross estate, for federal estate tax purposes, of only the payments made or due under the SCIN during the seller's life (and any income or appreciation attributable to such payments). The balance due under the SCIN, exclusive of any payments due but not made during the seller's life, will be cancelled and will escape inclusion in the seller's gross estate.[207] In this regard, G.C.M. 39503 states that "in the case of an installment sale, when a death-extinguishing provision is expressly included in the sales agreement and any attendant installment notes, the notes will not be included in the transferor's gross estate for Federal estate tax purposes." This removal of assets from the seller's gross estate is the primary motivation for using a SCIN.

The obvious tradeoff of a SCIN, of course, is that if the seller lives longer than he or she is "supposed to" and thus survives the end of the SCIN term, the assets included in the seller's gross estate will be greater, and possibly much greater, than if the seller had sold the property in a typical installment sale. Because of the risk premium, the SCIN payments will be materially higher than typical installment payments, and unless the payments are consumed or otherwise insulated from estate tax inclusion, they will be includible in the decedent's taxable estate. Depending upon the total return on the assets sold and interest rates, the estate tax inclusion could be even worse than if the seller had done nothing.

### *v.* Advantages and Disadvantages of SCINs

#### (a) Advantages

(i) **Estate Tax Savings Upon Early Death**. A SCIN should be used only when the seller is expected to die prior to his or her actuarial life expectancy. If the seller obliges by passing away prior to, and "preferably" materially prior to, his or her actuarial life expectancy, the estate tax savings can be quite substantial. In so many words, the seller in a SCIN transaction is gambling on his or her premature death.

(ii) **Interest Deductibility by Purchaser**. Unless the purchased property consists of personal use property (other than a primary or secondary residence), the interest paid by the purchaser under the SCIN should generally be deductible. This assumes that the purchaser in the SCIN transaction is not a grantor trust.

[206] *See* PLR 9535026.
[207] *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), *acq. in result only* 1981-1 C.B. 2.

(iii) **Purchaser's Basis**. Although the issue is not free from doubt, the basis of a purchaser (other than a grantor trust) in a SCIN transaction should be the initial principal obligation under the SCIN, including any principal premium. In contrast, the purchaser's basis for property purchased in a private annuity transaction may be limited to the aggregate annuity payments, which could result in a lower basis, especially if the seller dies prematurely (as anticipated).

(iv) **Backloading Payments**. A payment deferred under either a SCIN or a private annuity is a payment that may never have to be made. Backloading of payments is much more easily structured under a SCIN, as opposed to a private annuity. Conceptually, either interest or principal should be deferrable to a date within the seller's actuarial life expectancy, but an appropriate principal premium or interest premium would have to be calculated and ultimately paid (unless the seller dies before the due date). But *see Estate of Musgrove v. United States*[208], in which a demand SCIN transaction was held to be a gift because of the absence of a real expectation of repayment (since the seller was in poor health and the purchaser did not have other funds). This permissible backloading is a distinct SCIN advantage.

(v) **Collateralization of Payment Obligation**. The property sold in exchange for the SCIN can be used as security, thus better assuring the stream of payments if the seller is otherwise concerned that payments will not be made. In contrast, a private annuity should not be secured or guaranteed.[209]

(vi) **Interest Rate**. Although the issue is by no means free from doubt, there is a distinct possibility that the interest rate under the SCIN can be based on the generally lower AFR for the particular note pursuant to Section 7872, as opposed to 120% of the mid-term AFR under Section 7520. Whether use of the Section 7872 AFR is worth the gift tax risk and possibly the estate tax risk, however, is questionable at best.

(b) **Disadvantages**

(i) **Risk of Long Life**. Why there are so few SCIN transactions in practice.

(ii) **Tax Uncertainties**. As outlined above, the SCIN is replete with tax uncertainties.

(iii) **Income Tax Consequences for Seller or Her Estate**. If the seller dies before the SCIN matures, the deferred gain will be recognized for income tax purposes, upon cancellation of the note as of the seller's

[208] 33 Fed. Cl. 657 (Fed. Cl. 1995).
[209] *See* Banoff and Hartz 1986, at 146.

death, either in the deceased seller's final return or her estate's first return. It is less clear whether the same, or similar, income tax results will follow if the purchaser is a grantor trust.

**4. Private Annuities**

In the author's experience, private annuities are much discussed but rarely utilized. Now that the IRS has issued proposed regulations[210] eliminating the deferral of income taxation on the exchange of a private annuity for property (causing immediate realization of the fair market value of the annuity in the year of the exchange), the author expects their popularity to further erode.

In general, a private annuity is a contract providing for specified payments to the named annuitant for the annuitant's lifetime. Typically, one party agrees to transfer property to an individual for the right to a lifetime annuity. A private annuity is similar to a SCIN, except that payments continue for the annuitant's lifetime. The primary advantage of the private annuity is that the annuity amount can be determined from IRS valuation tables, eliminating speculation as to the annuity payments.[211]

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[210] Proposed Regulations § 1.1001-1, issued October 16, 2006.

[211] For a more comprehensive treatment of private annuities, *see* Hatcher 2007, ¶ VI.E., at 134; Stephan R. Leimberg & Leo C. Hodges, *The Income Tax and Estate Planning Advantages of Private Annuities*, 33 Estate Planning 3 (Feb. 2006).

PROMISSORY NOTE

$500,000.00 July 6, 2005

FOR VALUE RECEIVED, the undersigned hereby promises to pay to the order of **Millard Fillmore, Trustee of the Sally Fillmore Irrevocable Trust dated August 12, 1990,** at such place as the holders or holder may appoint, the principal sum of **Five Hundred Thousand Dollars ($500,000.00)** on demand, together with interest, compounded semiannually, on the unpaid principal amount of this Promissory Note from the date hereof until paid in full, at an initial rate per annum equal to the Federal short-term rate, as published by the Internal Revenue Service pursuant to § 1274(d) of the Internal Revenue Code (hereafter the "Federal short-term rate"), in effect for the month first above written. The interest rate on the unpaid principal amount of this Promissory Note shall be adjusted as of January $6^{th}$ and July $6^{th}$ of each year to the Federal short term rate in effect for such January and July, as the case may be.

At any time and without notice the undersigned, at its election, may pay without penalty or premium the outstanding principal amount of the Note in whole or in part together with accrued and unpaid interest thereon.

The undersigned hereby waives presentment for payment, demand, notice of dishonor, protest or any renewal or extension of the Note and consent to any such renewal or extension.

The promises, terms and conditions contained in this Note shall be binding upon the undersigned, their heirs, executors, administrators, personal representatives and assigns.

This Note shall be construed in accordance with and shall be governed by the laws of the State of New Jersey.

IN WITNESS WHEREOF, the undersigned hereby execute this Note as of the day and year first written above.

______________________________
Sally Fillmore

**EXHIBIT A**

# PROMISSORY NOTE

**$300,000.00** **March 1, 2005**
**_________ , California**

**FOR VALUE RECEIVED, STAN SMITH and SUSAN SMITH, individually, and as Trustee of the SMITH FAMILY TRUST** dated April 1, 1969, ("Maker") promise to pay to **G.E. SMITH and PATTI SMITH, as Trustee of the CBGB LIVING TRUST** dated October 31 1981, ("Holder"), or order at Coachella, California or at such other place as Holder may from time to time designate in writing, the principal sum of Three Hundred Thousand Dollars and no cents ($300,000.00), with interest from the date hereof on unpaid principal at the rate of three and seventy-six hundreds percent (3.76%) per annum, with interest payable annually, commencing on the 31st day of December, 2005, and continuing on the 31st day of each year thereafter, with the entire unpaid principal balance and all accrued interest due and payable on the 28th day of February, 2014. Interest not paid within thirty (30) days of the due date shall be added to principal.

## Default

Should default be made in the payment of any amount due under this Note, other than interest, or in the performance of any other obligation of Maker provided herein, or should Maker make an assignment for the benefit of creditors, or if a petition be filed by or against Maker under the provisions of any state insolvency law or under the provisions of the Bankruptcy Code, as amended, or should Maker become subject to the provisions of any Chapter of the Bankruptcy Code, as amended, the whole sum of principal and interest shall become immediately due at the option of the Holder. Failure to exercise such option shall not constitute a waiver of the right to exercise it in the event of any subsequent default. In the event that the Holder exercises such option, interest shall accrue thereafter on the then unpaid balance of principal at the rate of ten percent (10%) per annum.

## Prepayment Privilege

Maker may prepay the principal sum or any part thereof at any time without penalty or prepayment charge, provided that any such principal prepayment is accompanied by the payment of all accrued and previously unpaid interest on the amount of the principal so prepaid.

**EXHIBIT B**

**General Provisions**

A. All sums due hereunder shall be paid in lawful money of the United States of America.

B. Interest shall be computed on the basis of a 360-day year.

C. All payments made hereunder shall first be credited against accrued and previously unpaid interest; the balance shall be credited against principal, and interest shall thereupon cease on the principal so credited.

D. In this Note, the singular shall include the plural, each gender shall include the other, and this Note shall be the joint and several obligation of each Maker.

E. Maker, for itself and its legal representatives, successors and assigns, expressly waives demand, notice of nonpayment, presentment for demand, presentment for the purpose of accelerating maturity, dishonor, notice of dishonor, protest, notice of protest, notice of maturity and diligence in collection.

F. The section and subpart headings contained herein are for purposes of convenience and reference only and shall not affect in any way the meaning or interpretation hereof.

G. The obligation of Maker under this Note shall be joint and several.

________________ ________________________
Date STAN SMITH

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SUSAN SMITH

**"MAKER**"

**EXHIBIT B**