
# A Review of Income Tax Issues Associated With Intra-Family Loans & Installment Sales Series III of IV

This paper is the third in a four-part series exploring the issues surrounding intra-family loans and installment sales. Each series is summarized below. We've also included links to the first two series below for your convenience.

- **Part 1**: Loans and debt transactions between trusts and their beneficiaries, including the possibility of below market or interest free loans from trusts to, or for the benefit of, their beneficiaries as well as a review of IRC Section 7872, Section 483, and the so-called original issue discount ("OID") rules, primarily under IRC Sections 1272-1274. (Click here to review Part 1).

- **Part 2**: A review of the income tax rules associated with reportable installment sale transactions under IRC Section 453, including dispositions of reportable installment obligations during life, as well as the rules under Section 691 governing dispositions of reportable installment obligations as a result of death. (Click here to review Part 2).

- **Part 3**: Post-mortem tax considerations involving loans between a grantor and their grantor trust that remain outstanding at the time of the grantor's death when the grantor trust converts to a non-grantor trust.

- **Part 4**: Loans and debt transactions between family members and non-grantor trusts or other separate taxpayers, including potential application of IRC Section 754 to step-up the inside cost basis of partnership or LLC assets if LLC or partnership interests are purchased in a taxable transaction (albeit under the installment method of reporting under IRC Section 453).

## Overview:

This memorandum explores some of the open questions among practitioners regarding the income tax treatment of promissory notes issued by grantor trusts to their respective grantor in the event they remain outstanding at the grantor's death.

### Is the Note Considered an IRD Asset at Death?

Section 1012 governs the income tax basis rules of general application and provides that the basis of property shall be the cost of such property. However, Section 1012 includes an important qualifier that says, "except as otherwise provided in this subchapter." Section 1014(a) provides an "otherwise" by providing (in pertinent part) that "the basis in the hands of a person acquiring property from a decedent shall…be the fair market value of the property at the date of the decedent's death [or the alternate valuate date if applicable]." Section 1014 also has its own exception. Section 1014(c) provides that the general rule of Section 1014(a) shall not apply to any right to receive an item of income in respect of a decedent ("IRD") described under Section 691. The Regulations under Section 1.691(a)-1(b) provide that, in general, the term "income in respect of a decedent" refers to those amounts to which a decedent "was entitled as *gross income* but which were not properly includible in computing his taxable income or within the taxable year ending with the date of his death…under the method of accounting employed by the decedent."

As discussed in more detail in the prior series, Section 453 provides the fundamental framework of rules governing the installment method of accounting for otherwise taxable installment sales as well as the disposition of such obligations (i.e., dispositions of installment obligations other than those resulting from death itself governed instead by Section 691). Section 671 through Section 679 are commonly referred to as the grantor trust rules. Under those rules, a sale by the grantor to his or her own grantor trust during the grantor's lifetime is a disregarded transaction for income tax purposes. In those situations, installment sale reporting under Section 453 is simply not relevant since its operation is inapplicable. Such transactions are not reportable installment sale transactions, and they do not produce gross income to the seller while the seller is alive if the trust is a grantor trust with respect to the seller.

Given the foregoing, we think a strong argument exists that no IRD is generated if these types of notes remain outstanding at the grantor's death. Section 691 and the Regulations thereunder appear to expressly require that items of IRD must include items that would have otherwise been "gross income" to the decedent, but for the decedent's income tax accounting method which causes that gross income to fall outside the taxable year of the decedent's death. Well-known tax practitioners have made this point in published articles, but no case law precedent exists directly addressing this point. We believe a plain reading of the statute makes it more plausible that the correct view should be that the decedent's note receivable at death should not constitute an item that generates IRD and should therefore be entitled to a basis step up at death equal to the note receivable's fair market value (which may or may not equate to its face amount) under Section 1014.

### Special Rule Under Section 691 Depending on Identity of Obligor

Interestingly, if Section 691 is applicable to a promissory note that remains outstanding at the seller's death and the terms of the decedent's estate plan leave the note receivable to the obligor, Sections 691(a)(2) and (5) operate in conjunction with each other to accelerate the inherent gain of the note receivable transferred to the obligor as a result of death. This can create a circular argument depending on one's view of whether an outstanding grantor trust note represents an item of IRD or not (back to our argument above).

- If it is an item of IRD, it will not be entitled to a cost basis step up under Section 1014. As such, if the note is left to the obligor under the decedent's estate plan, then gain inherent in the note could be triggered immediately because the note will not have qualified for a basis step up at the grantor's death.

- If it is not an item of IRD, the issue is moot because the note should qualify for a basis step up at death under Section 1014 so no gain would result even if the note were left to the obligor. In effect, the note vanishes without tax consequences.

- If the decedent's estate plan leaves the note receivable to a person or entity other than the obligor, presumably Sections 7872 and 453 would govern the imputation of taxable interest and tax accounting for the capital gain of the note after the decedent's death in a manner consistent with the terms of the note. For example, if the note carries stated interest at the AFR and was structured as an interest only note with a balloon year, interest income will be reportable by the holder each year, but no capital gain would be recognized, if at all, until the balloon year.

- If the balloon note is not considered an item of IRD under Section 691 because it was not a reportable installment obligation under Section 453 during the grantor's lifetime, it will have qualified for a basis step up at death, resulting in little or no gain to be recognized in the balloon year. The extent of the promissory note's basis step up will depend on the promissory note's fair market value, including whether its fair market value is equal to its face amount. Whether the promissory note's fair market value equals its face amount is a question of valuation. If the promissory note's fair market value is ultimately determined by an appraisal to be worth less than its face amount, the promissory note's basis adjustment will be limited to its fair market value, which could leave open the opportunity for some gain to be recognized in the future when the promissory note's principal is received in the balloon year (or at the time the note is transferred in a transaction that accelerates the gain earlier).

- If, on the other hand, the note is considered an item of IRD, it will not have qualified for a basis step up, so the gain is preserved, albeit, deferred until the balloon year (unless the note is transferred in a transaction that accelerates the gain earlier).

**What is the Cost Basis of the Purchased Assets in the Hands of the Purchasing Trust Following the Grantor's Death When the Trust Converts to a Non-Grantor Trust?**

Regardless of the tax treatment of the note receivable following the grantor's death, clients and their advisors also must address the question of what becomes the cost basis of the assets that were purchased by the grantor trust. Section 1015 provides another "otherwise" to the general basis application rule in Section 1012 for transfers in trust. Regulation Section 1.1015-2 provides that in the case of property acquired after December 31, 1920, by transfer in trust (other than by a transfer in trust by gift, bequest, or devise) the basis of property so acquired is the same as it would be in the hands of the grantor, increased by the amount of gain, or decreased by the amount of loss, recognized by the grantor upon such transfer under the law applicable to the year in which the transfer was made.

*Example*

Assume asset XYZ was sold to an IDGT in year one for a $1 million promissory note with interest only at the AFR and a balloon payment of principal in the 10$^{th}$ year. The IDGT had been seeded with a lifetime cash gift of $100,000 before the sale. The basis of XYZ asset was $400,000 at the date of the sale in the hands of the seller. Assume the seller dies in year 4, when the unpaid balance of the note is $800,000 and the basis of the XYZ asset immediately before the seller's death remains $400,000. Assume that the trust was a wholly grantor trust to the seller until the seller's date of death.

Even though the above transaction was not a recognized sale for income tax purposes, a legal transfer has nevertheless occurred in trust that did not involve a gift, bequest, or devise. So, the starting point for basis of the trust assets following the grantor's death appears to be $400,000 since that was the seller's basis in the property and the seller neither recognized gain or loss as a result of the sale under the grantor trust rules.

The next question is whether the trust is permitted to increase its basis in the purchased asset by the debt it incurs to purchase the asset. Under Regulation Section 1.1012-1(g)(1), the general rule is that the basis of property is increased by the amount of debt incurred or assumed in connection with the purchase of property. However, in an IDGT transaction, there has not been a purchase that is recognized for income tax purposes. If there is no "sale" for income tax purposes, we find it difficult to conclude that the basis of the trust assets should be increased by the debt incurred by the trust. Moreover, Regulation Section 1.1015-2(a) referred to above says that we are to use the "law applicable to the year in which the transfer is made." Since there is no "sale" to invoke the application of Section 1001 for the year in which the sale occurred, we do not believe it is proper to assert that the basis of the purchased assets in the hands of the trust after death should be anything other than the $400,000 carryover basis of the seller.

**Possible Logic Tree**

Notwithstanding our views expressed above, we acknowledge that the tax treatment of outstanding grantor trust notes following the grantor's death remains a hotly debated topic. As such, we have attempted to provide the following logic tree as an aide to help clients and their tax advisors reach their own conclusion.

1. **Was the note issued by a wholly-grantor trust in favor of its grantor during the grantor's lifetime?**
   - If yes, proceed to items 2 and/or 3.
   - If no, then:
     - If the note receivable is left to the obligor under the decedent's estate plan, the note represents an item of IRD that does not qualify for a basis step up and gain inherent in the note is immediately triggered at death under Section 691(a)(2) and (5). Presumably, the obligor would have been entitled to a cost basis in the purchased asset at the time of the purchase equal to the purchase price (including the debt pursuant to Regulation Section 1.1012-1(g)(1)).
     - If the note receivable is not left to the obligor under the decedent's estate plan, the note will generate interest income to the holder according to its terms and will result in capital gain imputation to the holder under Section 453 as principal payments are made in accordance with the gross profit ratio calculation. As is the case above, the buyer of the assets would have been entitled to a cost basis in the purchased asset at the time of the purchase equal to the purchase price (including the debt pursuant to Regulation Section 1.1012-1(g)(1)).

2. **If it is determined that the note previously issued by the grantor trust <u>does</u> <u>not</u> represent an item of IRD, the note will be entitled to a step up in basis equal to the note's fair market value. Assuming the note's fair market value is equal to its face amount, then it is likely that the following conclusions are plausible:**
   - If the note receivable is left to the obligor under the decedent's estate plan, there is no gain triggered if the note's fair market value is equal to its face amount. If this were true, the note simply vanishes without tax consequences and the trust's basis in the purchased assets will represent the seller's carryover basis under Regulation Section 1.1015-2(a).
   - If the note receivable is not left to the obligor under the decedent's estate plan, the note will generate interest income to the holder according to its terms but no gain will be recognized by the holder as principal payments are made because the gross profit ratio of the note under Section 453 will essentially be zero. Additionally, the basis of the purchased asset in the hands of the trust/buyer after the grantor's death could be considered to be the seller's carryover basis. The trust may not be permitted to increase its basis in the purchased asset for any corresponding gain imputed ratably to the holder of the note pursuant to the calculation of the note's gross profit ratio.

3. **If it is determined that the note previously issued by the grantor trust represents an item of IRD, the note will not be entitled to a step up in basis. If this is the conclusion, then:**
   - If the note receivable is left to the obligor under the decedent's estate plan, the gain inherent in the note is immediately triggered at death. Presumably, this gain imputation allows the trust to increase its cost basis in the purchased asset from the seller's carryover basis by an amount equal to the gain recognized as a result of the deemed cancellation of the note.

- If the note receivable is not left to the obligor under the decedent's estate plan, the note will generate interest income to the holder according to its terms and will result in capital gain imputation to the holder under Section 453 as principal payments are made in accordance with the gross profit ratio calculation. Additionally, the basis of the purchased asset in the hands of the trust/buyer after the grantor's death could be considered to be the seller's carryover basis. The trust may not be permitted to increase its basis in the purchased asset for any corresponding gain imputed ratably to the holder of the note pursuant to the calculation of the note's gross profit ratio.

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