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

This paper is the last of 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 three series 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. (Click here to review Part 3).

- **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 the complex interplay between the partnership income tax rules of IRC Section 754 governing inside basis adjustments to partnership assets upon the sale of a partnership interest to an irrevocable non-grantor trust in exchange for an installment promissory note governed by IRC Section 453.

Partnership Tax Fundamentals

Subchapter K of the Internal Revenue Code governs the taxation of partners and partnerships. In general, entities taxed as partnerships do not pay income tax but are often referred to as pass-through entities. This means that the partners bear the ultimate tax burden for the activity generated by the partnership. This differs from basic corporate taxation principles where the corporate entity itself pays its own income tax and shareholders pay a second level tax on dividends.

Depending on the situation, Subchapter K may employ either an entity approach or an aggregate approach. Under an entity approach, the partnership is treated as separate and independent from its partners. Alternatively, an aggregate approach is applied in other situations to treat each partner as owning an undivided fractional interest in the entity's underlying partnership assets as if they owned them directly.

One example of applying the entity approach within Subchapter K is the recognition of a partner's basis in their partnership interest (the outside basis) as separate and distinct from the partnership's basis in its underlying assets (the inside basis).

Alternatively, an example of the aggregate approach involves an installment sale of a partnership interest by a partner if the partnership owns assets that are considered "hot assets" under IRC Section 751. Hot assets under IRC Section 751 have similarities with the types of assets listed under IRC Section 453 that are not eligible for installment sale treatment, but the lists are not identical.

IRC Section 751 provides that when a transferor partner receives consideration for all or a part of their partnership interest, the portion attributable to the partnership's unrealized receivables, substantially appreciated inventory, or depreciable assets subject to ordinary income recapture shall be considered as an amount realized from the sale or exchange of a non-capital asset (not eligible for installment sale treatment). Essentially, the provision shifts the tax treatment from an entity approach to an aggregate approach, ensuring that a partner cannot avoid ordinary income taxation by structuring the transaction as a sale of the partner's partnership interest rather than as a deemed sale of the partner's fractional share of the underlying "hot assets."

At the formation of the partnership, parity is achieved because the contributing partner's basis in contributed assets serves as both the partner's initial outside basis in their partnership interest (referred to as a substituted basis) and the partnership's inside basis in the contributed assets (referred to as carryover basis). However, the application of the entity or aggregate approach in different situations may give rise to differences between the partnership's inside basis and a partner's outside basis in their partnership interest over time.

To preserve the pass-through nature of taxation so that only a single level of tax is incurred, inside basis adjustments to the partnership's underlying assets may become necessary when a partner dies or transfers their partnership interest. This memorandum explores this phenomenon in the context of a partner executing a taxable installment sale with an irrevocable non-grantor trust. If structured properly, such a transaction has the potential to allow families to immediately convert substantially appreciated assets to cash or other diversified assets while deferring income taxes over an extended period. This type of planning also may produce significant estate planning benefits by removing post-transfer appreciation from the selling partner's taxable estate.

The chart on the next page highlights a few entity versus aggregate approach concepts adopted by the Internal Revenue Code in determining whether an installment sale of a partnership interest is respected based on the attributes of the partnership's underlying assets or activity.

Two examples that may be most helpful in illustrating the competing tension between both approaches involve: (i) a partner's installment sale of their partnership interest in a partnership that owns underlying marketable securities, and (ii) a partner's installment sale of their partnership interest in a partnership that owns depreciable property.

<table>
<thead>
<tr><th>IRC Section 453
"Disqualified Assets"</th><th>IRC Section 751
"Hot Assets" & Situations Where Debt Exceeds Partner's Outside Basis Under IRC Section 752</th></tr>
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<tbody>
<tr><td>Sales of Inventory. The sale of inventory in the ordinary course doesn't qualify for installment sale treatment even if the seller receives payments after the year of sale.</td><td rowspan="4">Unrealized Receivables. A partner's fractional share of a partnership's unrealized receivables is a "hot asset" under Section 751 and will therefore not qualify for capital gains that can be deferred under the installment sale rules.</td></tr>
<tr><td>Dealer Sales. Sales of real estate to customers in the ordinary course of a trade or business do not qualify for installment sale reporting. However, the disqualification rule doesn't apply to an installment sale of property used or produced in farming.</td></tr>
<tr><td>Publicly Traded Stock or Securities. Installment sale treatment cannot be used to report gain from the sale of stock or securities traded on an established securities market. Sellers must report the entire gain on these transactions in the year in which the trade date falls.</td></tr>
<tr><td>Depreciation Recapture Income. If the seller sells property for which they claimed a depreciation deduction, they must report any depreciation recapture income in the year of sale, regardless of whether or not an installment payment was received that year. Taxpayers may compute their depreciation recapture income on Form 4797. The recapture income reported in the year of sale is included in the seller's installment sale basis for purposes of calculating their gross profit ratio for the portion of the gain that exceeds the depreciation recapture income.</td></tr>
<tr><td>Sale of Depreciable Property to Related Buyer. If there is a sale of depreciable property between "related persons," as defined in section 453(g)(3), the installment method is unavailable for the transaction. In that case, all payments to be received pursuant to a sale of depreciable property are treated as received in the year of sale. Sales between a grantor and a non-grantor trust for descendants are not considered "related." Sales between a grantor and a non-grantor trust for the grantor's spouse and descendants are considered "related."</td><td rowspan="2">Substantially Appreciated Inventory. A partnership's inventory is substantially appreciated if its fair market value is 120% of its cost. A partner's fractional share of a partnership's substantially appreciated inventory is a "hot asset" under Section 751 and will therefore not qualify for capital gains that can be deferred under the installment sale rules.</td></tr>
<tr><td>Related Party Resales Within 2 Years. Section 453(e) provides that if property is sold to a related party in exchange for an installment promissory note and the purchased property is resold by the related party within two years of the original purchase, then the amount realized by the related party will be treated as a payment to the original seller. Thus, the deferred gain on the note is accelerated at the time of the second sale (to the extent of the amount realized on the second sale). Sales between a grantor and a non-grantor trust for descendants are not considered "related." Sales between a grantor and a non-grantor trust for the grantor's spouse and descendants are considered "related."</td></tr>
<tr><td>Anti-Abuse Provisions. Section 453(k) gives the IRS authority to issue regulations disallowing the use of the installment method for transactions where the restrictions barring use of the installment method for sales of publicly traded property would be avoided by use of related parties, pass-through entities, or intermediaries. To date, these Treasury Regulations have not been promulgated.</td><td rowspan="2">Depreciation Recapture Assets & Negative Basis. Section 751(c) treats a selling partner's share of the partnership's underlying assets that are subject to ordinary income from depreciation recapture as "hot assets." Additionally, a partner's share of debt in excess of their outside basis at the time a partner transfers their partnership interest becomes immediately recognizable phantom gain under IRC Section 752 and Treasury Regulation 1001-1.</td></tr>
<tr><td>Sale of Partnership Interest (With Underlying "Hot" Assets). A partner who sells a partnership interest at a gain generally is permitted to report the sale on the installment method. The sale of a partnership interest is treated as the sale of a single capital asset. This is true even if the underlying partnership assets consist of publicly traded marketable securities or depreciable assets. However, there is a "look-thru" rule that applies to prevent installment sale treatment of any gain or loss from any portion of the partnership's underlying Section 751 assets that are from unrealized receivables, substantially appreciated inventory, assets that produce ordinary income from depreciation recapture, or any other assets that would otherwise be treated as ordinary income if sold directly.</td></tr>
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Source: Internal Revenue Code

Refreshing Basis and Resurrecting Depreciation

If there is a sale of depreciable property between a seller and buyer, the seller must recognize any income recaptured as ordinary income under IRC Sections 1245 and 1250 of the Internal Revenue Code in the year of sale, but any portion attributable to capital gain continues to qualify for installment sale reporting unless the buyer is related to the seller. It is worth noting that an irrevocable non-grantor trust is generally not considered related to its grantor unless the grantor's spouse is a beneficiary of the trust. Moreover, an installment sale of a partner's partnership interest to an irrevocable non-grantor trust that benefits the seller's spouse and descendants should not, per se, prevent installment sale treatment just because the partnership may own depreciable real estate unless the IRS were successful in arguing that the existence of the partnership should be disregarded and treat the transaction as a sale of depreciable real estate rather than a sale of a partnership interest in a partnership that owns depreciable real estate.

IRC Section 1250 states that upon a sale or exchange of depreciable real property, all or part of any depreciation deductions in excess of straight-line depreciation are recaptured as ordinary income. IRC Section 1245 generally provides that upon a sale of depreciable personal property, the amount of gain equal to all prior depreciation deductions is recaptured as ordinary income. If a taxpayer sells depreciable investment real estate that is not recaptured under IRC Section 1250 as ordinary income, it is unrecaptured section 1250 gain. Additionally, IRC Section 751(c) excludes a partner's share of a partnership's unrecaptured section 1250 gain from the calculation of recapture income that must be immediately recognized at the time of the installment sale of a partner's partnership interest.

The applicable straight-line recovery period for (i) residential rental property is 27.5 years; (ii) nonresidential real property is 39 years, and (iii) certain land improvements is 15 or 20 years. Depreciation deductions can offset rental income, which is taxable at Federal ordinary rates of 37% today and 39.6% after 2025 under the current tax law. When depreciable property is sold, the Internal Revenue Code taxes unrecaptured section 1250 gain (recognized as the amount of straight-line depreciation taken on the property) at a maximum rate of 25%. This provides the owner of the property with a tax arbitrage savings of 12% to14.6% (i.e., 37%/39.6% less 25%), and disregards the time value of the deductions prior to the recapture of those deductions (when there is a taxable sale in the future).

Aside from recapture income that generates ordinary income immediately, the sale of a partnership interest to an irrevocable non-grantor trust for an installment note potentially allows the partnership to increase its inside basis in its depreciable property with an IRC Section 754 election before selling the property for cash to a third-party buyer for little or no gain. In the case of an installment sale of a partner's interest, structuring the transaction as an interest only/balloon note would allow the historical unrecaptured section 1250 gain to delay recognition until the maturity date of the note.

As a result of the intervening installment sale of the partner's interest to an irrevocable non-grantor trust and the partnership's corresponding IRC Section 754 inside basis election, the partnership is able to purchase replacement property with full basis with little or no gain recognition. Given the right set of facts, this allows for "refreshing basis" and "resurrecting depreciation deductions" in a manner that an IRC Section 1031 like-kind exchange cannot achieve. For example, if a partnership holds fully depreciated real estate on a straight-line basis at a time when its inside basis is zero and exchanges it for qualified replacement property pursuant to an IRC Section 1031 like-kind exchange, the inside basis in the qualified replacement property will carryover from its historical relinquished property, thus preventing further deductions of depreciation in the qualified replacement property since the basis has been fully recovered.

<u>Section 453A – Interest Charge on Deferred Payment Sales in Excess of $5 Million</u>

Installment sellers in certain large transactions are required to pay an additional tax each year that is computed like a deemed interest charge. The deemed interest charge is intended to compensate the Treasury for the delay in the payment of the regular tax on installment gains. The additional tax generally applies to gains on all installment sales with a property price greater than $150,000 if the taxpayer holds installment obligations from all sales throughout the year in an aggregate principal amount exceeding $5 million at year end. We have provided commentary in an earlier white paper (Series II of IV) that provides further details about installment sales and Section 453A. As the example on the next page illustrates, a married couple can avoid the IRC Section 453A imputed interest charge on installment sales up to $10 million if structured properly.

Example:

AB Partnership owns a concentrated marketable security with an adjusted basis of zero and a fair market value of $2,000,000. AB Partnership also owns $8,000,000 of other assets with an adjusted basis of zero that are eligible for installment sale treatment. Partner A and B are married. Upon satisfying certain advance notice requirements, the AB Partnership allows each partner to request a redemption of their partnership interest at "net asset value" without valuation discounts applied for lack of marketability or the fact that their partnership interest may represent a non-controlling voting or non-voting interest. Both Partner A and Partner B sell a 49% interest (98% in total) in the AB Partnership for a total of $9,800,000 to a non-grantor trust for the benefit of A and B's descendants in exchange for two installment promissory notes. Each provides for interest only payments for 20 years and a balloon payment of principal in year 20. AB Partnership has an IRC Section 754 election in place, so under IRC Section 743(b), the adjusted inside basis of the marketable security is increased to $1,960,000 and the adjusted inside basis of the other assets is increased to $7,840,000. If AB Partnership thereafter sells its assets, it will only recognize a gain of $200,000, which will be allocated to A and B. The incremental gain is outweighed by the benefits of immediate diversification of the underlying partnership assets, in addition to deferral of 98% of the embedded unrealized gains until year 20 when the promissory note ballon payments are satisfied.

Using Partnerships to Multiply the $5 Million Threshold

In IRS Notice 88-81, the IRS ruled that the $5 million threshold stated above will be applied at the partner level. As such, a partnership is a convenient way to multiply the $5 million threshold among the partners, allowing the partners to further minimize or avoid the interest imputation rules discussed above under IRC Section 453A.

Example:

XYZ Family Partnership owns highly-appreciated assets worth $50,000,000. None of the assets are "hot assets" under IRC Section 751. The partnership's assets consist primarily of a combination of unimproved real estate, marketable securities and alternative investments. As a result of prior gift planning more than three years ago from the filing of gift tax returns, the current owners of the partnership consist of the parents, A and B, who each own 1% voting interests and 9.8% non-voting interests. Additionally, three children and five grandchildren each own 9.8% non-voting interests. Recently, the partners decided to amend the partnership agreement to allow each partner to request a redemption of their partnership interest at "net asset value" without valuation discounts applied for lack of marketability or the fact that their partnership interest may represent a non-controlling voting or non-voting interest. Assume each partner engages in an installment sale of their 9.8% non-voting interests to an irrevocable non-grantor trust created by A for the benefit of B and their descendants. Distributions from the irrevocable non-grantor trust require majority consent from the distribution committee (consisting of the children of A and B). Each partner receives a promissory note with a face amount of $4.9 million. Each note provides for interest only payments for 20 years at the AFR and a balloon payment of principal in year 20. Based on the rationale of IRS Notice 88-81, none of the partners should be subject to the imputed interest rules discussed above under IRC Section 453A.

Hypothetical Case Study

Patriarch and/or Matriarch create Parent Holding Company LLC or identify an existing family LLC that can serve as Parent Holding Company LLC.

If an existing LLC will serve as the Parent Holding Company LLC, the family could recapitalize the ownership into voting LLC interests and non-voting LLC interests.

The Operating Agreement could be amended to grant its members with a “put option” or unilateral right of redemption equal to the fair market value of the partner’s net asset value in the partnership without factoring in discounts for lack of marketability or minority interest.

Patriarch and/or Matriarch each create irrevocable non-grantor trusts for the benefit of each other and their descendants. Each would include sufficient differences to mitigate the reciprocal trust doctrine.

The Patriarch and/or Matriarch sell their non-voting LLC interests to the respective irrevocable non-grantor trusts for long-term interest only/balloon installment notes governed by IRC Section 453.

The Parent Holding Company LLC makes an IRC Section 754 election to increase the inside basis of its assets (including its cost basis in any sub-LLCs that it owns) to reflect the face amount of the installment promissory notes issued in exchange for the selling partner’s partnership interest.

The Parent Holding Company LLC (or the sub-LLCs) later sell their underlying assets for their fair market value to a third party buyer as part of a contemplated liquidity event and the proceeds are reinvested into a diversified portfolio at the Parent Holding Company LLC (or sub-LLC) level. As a result, the immediate capital gains recognition is mitigated because of the step up in the inside basis of the LLC assets before the liquidity event.

The Parent Holding Company LLC makes annual cash distributions to the irrevocable non-grantor trusts in order for them to service interest on their respective promissory notes to Patriarch and/or Matriarch.

The irrevocable non-grantor trusts make balloon payments of note principal to Patriarch and/or Matriarch at the end of their respective note terms and capital gains taxes become due at that time, thereby deferring the payment of capital gains for an extended period.

Potential Advantages

Combining the benefits of IRC Section 754 and IRC Section 453 allows family partnerships to potentially convert their substantially appreciated assets to cash immediately while mitigating upfront income taxes despite the fact that the selling partner is permitted to defer their capital gains taxes under the installment sale rules of Section 453 until the balloon year of their installment note.

Without the ability to make an IRC Section 754 election, the family unit will have been taxed twice, once on the sale of the partnership interests in the LLC (albeit in the balloon year) and again when the LLC sells its underlying assets. The IRC Section 754 election preserves the single level tax regime applicable to partners and their partnerships as distinguished from the double tax regime applicable to corporations other than S corporations.

The above planning transaction generates estate/gift and asset protection benefits by shifting all post-transfer appreciation out of the taxable estate into the irrevocable non-grantor trusts beyond the reach of the creditors of the beneficiaries. Additionally, this allows the family to diversify concentrated assets without further delays, which potentially allows them to reduce their overall portfolio risk if the underlying LLC assets consist of low basis marketable securities, real estate or other assets that present significant concentration risk.

The table on the next page illustrates the potential income tax deferral benefits if each of the Patriarch and the Matriarch elect installment sale treatment over $5 million of partnership interests with a hypothetical zero outside basis. The farthest right hand column details the economic benefits achieved based on different deferral periods utilized for the balloon year.

Deferral Period (Years)	Hypothetical Gain Deferred	Assumed Combined Effective Tax Rate Applicable to Gains	Tax Due Without Deferral	Present Value of Tax Payable At End of Deferral Period	Present Value of Deferral Benefit
5	10,000,000	28.8%	2,880,000	2,367,150	512,850
10	10,000,000	28.8%	2,880,000	1,945,625	934,375
15	10,000,000	28.8%	2,880,000	1,599,162	1,280,838
20	10,000,000	28.8%	2,880,000	1,314,394	1,565,606
25	10,000,000	28.8%	2,880,000	1,080,336	1,799,664
30	10,000,000	28.8%	2,880,000	887,958	1,992,042
35	10,000,000	28.8%	2,880,000	729,837	2,150,163
40	10,000,000	28.8%	2,880,000	599,872	2,280,128

Note: The above chart assumes 4% as the discount rate for all present value calculations (Colony's internal assumption)

Potential Disadvantages

Ordinary income recapture will be due for the tax year of the installment sale to a non-grantor trust to the extent a portion of the installment note is attributable to the Parent Holding Company LLC's share of "hot assets" such as IRC Section 1245 depreciable personal property, IRC Section 1250 depreciable real property (to the extent of accelerated depreciation), substantially appreciated receivables and inventory.

An installment sale of a partnership interest at a time when the selling partner's share of allocable partnership debt exceeds the selling partner's outside basis will generate phantom gain at the time of the installment sale under Treasury Regulation Section 1.1001-1 and IRC Section 752(d).

As such, engaging in an IRC Section 754 strategy if (i) ordinary income recapture exists or (ii) when debt exceeds outside basis, could cause the unintended acceleration of phantom recapture income or gain before the ultimate liquidity event occurs. For example, if Patriarch and Matriarch each engage in an installment sale of Parent Holding Company LLC units for $5 million each at a time when $200,000 of the total $10 million purchase price is allocable to related "hot assets" owned in one or more sub-LLCs, then ordinary income taxes will be assessed upfront against $200,000 of phantom ordinary income recapture in the year of the installment sales (which may occur well before cash is received from the partnership's eventual third-party liquidity event).

If Patriarch and Matriarch also decide to fund the LLC with diversified portfolio assets that pay dividends, upon the sale of their partnership interests in the LLC, they will effectively convert their dividends on the underlying portfolio (currently taxed at 28.8%) to interest income (potentially taxed at 45.8%) assuming a state tax rate of 5.0%. This is so because the note interest payments are characterized as ordinary income. In contrast, the dividends generated by the underlying assets would be characterized as qualified dividends, which are allocable to the obligor trusts as the new owners of the LLC. However, the obligor trusts will be entitled to an interest expense deduction. Additionally, the higher ordinary income taxes owed by the Patriarch and Matriarch reduce the taxable estate at a faster rate over time by paying more in income taxes each year while the obligor trusts, which are outside the taxable estate, continue to enjoy an income tax deduction benefit for the interest expense that offsets the taxes they might otherwise owe on their qualified dividends.

To avoid grantor trust status, the irrevocable trusts created by Patriarch and Matriarch must require the consent of one or more of the non-spousal beneficiaries before any of the trusts can make a distribution to the spousal beneficiary.

Although there are numerous favorable rulings interpreting the correct use of an IRC Section 754 election, there are no specific rulings or statutes which specifically address the income tax consequences of the strategy described above. While many commentators believe the strategy above should be respected, it could potentially be challenged by the IRS since the strategy generates a significant income tax deferral benefit.

Advanced Planning: Combining Partnerships, S Corporations and Installment Notes

The results discussed above might be improved at the deaths of Patriarch and Matriarch if they were to initially contribute their interests in Parent Holding Company LLC to separate S corporations and then cause their S corporations to enter into installment sales by selling their interests in Parent Holding Company LLC to irrevocable non-grantor trusts. As a result, Parent Holding Company LLC would elect under IRC Section 754 to immediately increase the inside basis of its assets to equal the face amount of the notes.

At the eventual death of Patriarch or Matriarch, their S corporation stock will become entitled to a basis step-up equal to the date of death value of their S corporation stock. The primary asset of each S corporation would be its underlying note receivable. If each irrevocable non-grantor trust prepays their $5 million outstanding note to the S corporation in the same year of death and the decedent's estate thereafter liquidates the S corporation in the same tax year, an opportunity is created to completely eliminate the $5 million inherent gain of each S corporation's note receivable. This is so because the decedent's estate becomes entitled to an offsetting loss deduction upon redemption of the estate's S corporation stock in liquidation of the S corporation by virtue of the basis step-up of the decedent's S corporation stock held at death.

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