Authorized Reprint
Journal of Taxation of Investments
Civic Research Institute

# Catching the Wave: Reassessing Wealth Transfer Plans in Light of Current Economic Conditions

Michael R. Pieczonka*

*The current market of severely depressed asset values; the increased $5 million lifetime gift, estate, and generation skipping transfer (GST) tax exemption amounts set to expire at the end of 2012; and all-time low interest rates make now an opportune time for an individual to reassess his or her wealth transfer plan, or to create one for the first time. This article discusses the appropriate Applicable Federal Rate (AFR) for individuals who are creating a wealth transfer plan for the first time which utilizes an intentionally defective grantor trust (IDGT), family limited partnership (FLP), and installment sale promissory notes (ISPNs). Additionally, several alternatives are discussed regarding the substitution of an existing ISPN at a higher AFR for a new ISPN at the current lower AFR for individuals with existing wealth transfer plans consisting of an IDGT, FLP, and ISPN. The gift, estate, GST, and income tax ramifications are detailed.*

## Introduction

The Iraq and Afghanistan Wars will cost Americans $1.38 trillion by the end of 2012.[1] The American Recovery and Reinvestment Act of 2009[2] will cost Americans $787 billion;[3] the President signed into law the Health Care and Education Reconciliation Act of 2010[4] with a price tag of $1.055 trillion; as of

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* Michael R. Pieczonka, C.P.A., J.D., L.L.M., is a contract attorney with Handler Thayer, LLP. He may be reached by email at mpieczonka@handlerthayer.com.

1 Amy Belasco, "The Cost of Iraq, Afghanistan, and Other Global War on Terror Operations Since 9/11" (U.S. Congressional Research Service, RL 33110; Mar. 29, 2011), available at http://www.fas.org/sgp/crs/natsec/RL33110.pdf.

2 P.L. 111-5, 123 Stat. 115.

3 N.Y. Times, "Credit Crisis—The Essentials," updated Oct. 7, 2009, available at http://evanscraig.wordpress.com/2009/10/07/nytimes-com-credit-crisis-the-essentials/.

4 P.L. 111-152, 124 Stat. 1029.



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July 2011 China owned $1,173.5 billion of U.S. debt;[5] and President Obama recently introduced the American Jobs Act of 2011, which, if enacted, will cost the American people an additional $447 billion.[6] With all of this spending by the federal government, the increasing debt and deficit, and the credit rating downgrade by Standard and Poor's, a comprehensive tax increase may well be part of the 2013 congressional agenda. Any comprehensive tax increase will obviously affect high-wealth individuals.

This article highlights how estate planners (EPs)[7] can counteract a tax increase agenda, specifically regarding high-wealth individuals, by utilizing wealth transfer plans. First, the article explains grantor trusts, family limited partnerships (FLPs), valuation discounts, and installment sale promissory notes (ISPNs), and how EPs use them as a wealth transfer vehicle for high-wealth individuals. The next several sections analyze the various options that EPs have to successfully substitute a new ISPN with a lower Applicable Federal Rate (AFR) for an original ISPN with a higher AFR without incurring any tax liability. Finally, the article proposes two scenarios: (1) recommending the AFR EPs should implement for ISPNs between intentionally defective grantor trusts (IDGTs) and the grantor upon creation of a current wealth transfer vehicle, and (2) the income, estate, gift, and generation skipping transfer (GST) tax consequences of substituting a new ISPN for an already existing note.

## Background—The Available Planning Vehicles

**Intentionally Defective Grantor Trusts.** A grantor trust is a trust that treats the grantor as the owner of the trust income and principal for income tax purposes.[8] All income, deductions, and credits of the trust are the grantor's regardless of any distributions to the grantor or any other individual.[9] With careful drafting, an irrevocable trust can be structured as a grantor trust while excluding the trust assets from the grantor's gross taxable estate, commonly

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[5] Posting of David Manuel to http://www.davemanuel.com/us-national-debt-clock.php (accessed Oct. 18, 2011).

[6] Heather Boushey & Gadi Dechter, "The American Jobs Act, A Bill Worthy of Its Name" (Center for American Progress, Sept. 14, 2011), available at http://www.americanprogress.org/issues/2011/09/american_jobs_act.html. See also H.R. 12, 112th Cong. (2011); S. 1549, 112th Cong. (2011).

[7] The term "estate planners" includes attorneys, accountants, financial planners, and others who draft estate wealth transfer plans.

[8] Jonathan G. Blattmachr, Bridget J. Crawford & Elisabeth O. Madden, "How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note," 109(1) J. Tax'n 22, 25 (2008).

[9] See generally IRC §§ 671-679 (indicating that all items of trust income, deduction, and credit are reported by the trust's grantor); Rev. Rul. 85-13, 1985-1 CB 184 (ruling that the trust and the grantor are a single entity, making a bona fide sale or debt obligation impossible).

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referred to as an IDGT. Utilization of an IDGT can lead to substantial estate planning benefits, such as:

- Tax-free gifts that appreciate free of estate and GST taxes for future generations, assuming lifetime GST tax exemption was allocated to the gift;
- Tax-free sales and exchanges;
- Disregarding debt instruments between the grantor and grantor trust; and
- Additional tax-free gifts from the grantor to the IDGT beneficiaries because the grantor pays the income tax liability of the IDGT.

Prior to 2004, the Internal Revenue Service's formal position was that a grantor's payment of taxes on the income of a grantor trust was a gift to the trust's beneficiaries.[10] In Revenue Ruling 2004-64, the IRS issued formal guidance on the corresponding estate and gift tax consequences. Pertaining to gift tax issues, the IRS ruled that, because the trust income was included in the grantor's taxable income, the income tax paid by the grantor was not a gift to the trust beneficiaries.[11] The IRS's position allows a grantor to exceed the applicable gift and estate tax exemption amounts to reduce, dollar for dollar, the grantor's estate by paying the income tax of the trust. In effect, the income tax paid by the grantor on the trust's income constitutes additional tax-free gifts to the trust beneficiaries.[12]

Again, for income tax purposes, the grantor is treated as the owner of the trust property, and a sale of appreciated property by the grantor to the trust will not result in a taxable transaction. However, such a sale is considered a completed gift for gift tax purposes and removes the property from the grantor's taxable estate. As a result, the grantor can sell appreciated property to the IDGT without recognizing any gain for income tax purposes. In addition, the grantor is treated for income tax purposes as the debtor of any trust liabilities.[13] Therefore, any debt instruments between the grantor and the IDGT, and any interest payments thereon, are disregarded for income tax purposes

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[10] See generally PLRs 9504021 (Oct. 28, 1994), 9444033 (Aug. 5, 1994), 9416009 (Dec. 30, 1993), 9413045 (Jan. 4, 1994), and 9352004 (Sept. 24, 1993) (advancing the IRS's argument that the payment of the grantor trust's income tax by the grantor was a gift to the beneficiaries of the grantor trust). See also "Irrevocable Grantor Trusts—Payment of Income Tax Liability by Grantor," 36 Tax Mgmt. Memo. 153 (BNA, 1995); Carmela T. Montesano & Ann St. Laurent, "Defective Grantor Trusts: Gift Tax Consequences of Payment of Income Tax Liability by Grantor," 20 Tax Mgmt. Est., Gifts & Tr. J. 183 (1995).

[11] Rev. Rul. 2004-64, 2004-2 CB 7.

[12] Deborah V. Dunn & David A. Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates," 95 J. Tax'n 49 (2001).

[13] Id.

because a debt owed to oneself has no income tax implications. EPs routinely create IDGTs to further transfer wealth from the grantor to future generations free of estate, gift, and GST taxes.

**Family Limited Partnerships.** The terms "family limited partnership" and "family limited liability company" are tax jargon used by EPs and are not found anywhere in the Internal Revenue Code. However, as with any type of partnership there are two forms of family partnerships: (1) a "family general partnership" and (2) a family limited partnership.[14] FLPs have become an essential element of many estate plans because they offer the opportunity to transfer a share of the grantor's assets to other family members and future generations at a substantially reduced gift tax cost.[15] In addition, the transferred assets will appreciate free of estate, gift, and GST taxes for future generations, assuming lifetime GST tax exemption was allocated to the gifted assets. FLPs also provide nontax benefits, such as asset protection. Limited liability companies (LLCs) have become increasingly popular among EPs and their clients, and are being used more and more frequently for estate planning purposes.

FLPs offer numerous advantages to transfer family wealth, including, but not limited to:

- Ease of creation;
- Elimination of ancillary probate when funded with real estate located in a state in which the grantor does not reside;
- Retention by the grantor of managerial control over the property being transferred;
- Being a disregarded entity for income tax purposes;

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[14] The Uniform Partnership Act ("UPA") defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit." J. William Callison & Maureen A. Sullivan, *Partnership Law and Practice: General and Limited Partnerships,* § 2:3 (2008). The UPA defines a general partnership ("GP") as "a business organization consisting of two or more persons, all of whom are general partners with full status as such." Id. The UPA states that a limited partnership ("LP") consists "of one or more general partners and one or more limited partners." Id. at § 2:4. Limited partners are usually passive investors who do not participate in day-to-day decisions and operations, are liable only up to their initial investment, and share in partnership profits and losses. Id. On the other hand, general partners have unlimited liability, participate in the day-to-day operations and decisions, and participate in profits and losses. Id. See generally John E. Moye, *The Law of Business Organizations* 1 (2d ed. 1982) (covering sole proprietorships, partnerships, and corporations); Howard M. Zaritsky, *Tax Planning for family Wealth Transfers: Analysis With Forms*, § 10. 04 (4th ed., 2009) (discussing the family limited partnership versus the family general partnership). The usage of FLP in this article refers collectively to both family limited partnerships and family limited liability companies.

[15] Zaritsky, supra note 14, at § 10.01.

- Utilization of multi-class partnership interests to freeze the value of the interest of a deceased partner for estate tax purposes;
- Protection from the claims of the beneficiaries' creditors; and
- Gifts made outright or in trust may be eligible for the annual gift and GST tax exemption amounts.

**IRC Section 7872 and Below-Market-Rate-Interest Loans.** Section 7872 was enacted by Congress in response to the seminal United States Supreme Court case *Dickman v. Commissioner,*[16] decided in 1984. *Dickman* involved a lender making interest-free loans to a relative and to a closely held corporation, which the Court characterized as taxable gifts. Accordingly, the IRS quickly issued Announcement 84-60, providing guidelines for computing the gift value of interest-free loans.[17] Subsequently, Congress enacted Section 7872 as part of the 1984 Tax Reform Act because it was concerned about the income-shifting potential of interest-free loans the Court identified in *Dickman*.[18] Prior to enactment of Section 7872, interest-free loans between family members, corporations and corporate shareholders, and corporations to persons providing services were being made to avoid income and gift tax laws.[19]

***Operation of Section 7872.*** Section 7872 regulates "below-market loans," defined as loans with respect to which either no interest, or interest below the AFR, is charged.[20] The term "loan" is to be interpreted broadly for purposes of Section 7872.[21] Below-market loans are categorized by their repayment terms and are either demand loans or term loans. Section 7872 applies to the five types of term and demand loans:

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[16] See generally Dickman v. Comm'r, 465 U.S. 330 (1984) (involving interest-free loans to a related party and closely held business).

[17] See generally IRS Ann. 84-60, 1984-23 IRB 58 (limiting the scope of interest-free loans to those to which the reasoning of *Dickman* would apply).

[18] See generally Staff of Joint Comm. on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984,* 98th Cong., available at http://www.jct.gov/jcs-41-84.pdf (discussing the implications of the revenue provisions of the Deficit Reduction Act of 1984, which was H.R. 4170 and P.L. 98-369).

[19] Loans between family members were being used to avoid assignment of income and grantor trust rules; loans from corporations to shareholders were being used to avoid rules requiring taxation of income at the corporate level; and loans to persons providing services were being used to avoid employment taxes and rules restricting deductibility of interest in certain situations by the person providing services. See J. Martin Burke & Michael K. Friel, *Taxation of Individual Income* (7th ed. 2004), at 821.

[20] IRC § 7872(e)(1).

[21] Prop. Treas. Reg. § 1.7872-2.

1. *Gift:* A gift loan is a below-market loan in which the forgone interest is a gift;[22]
2. *Corporation-shareholder:* A corporation-shareholder loan is a below-market loan directly or indirectly between a corporation and its shareholders;[23]
3. *Compensation-related:* A compensation-related loan is a below-market loan directly or indirectly between an employer (or a party for whom an independent contractor provides services) and an employee (or independent contractor);[24]
4. *Tax-avoidance:* A tax-avoidance loan is a below market loan for which one of the principal purposes of the interest arrangements is the avoidance of any federal tax;[25] and
5. "*Significant-effect*" *:* A "significant-effect" loan is a below-market loan, to be determined by regulations, where the interest arrangements have a significant effect on any federal tax liability of the lender or borrower.[26]

In the case of a term note (other than a gift term note) that charges the AFR, for purposes of Section 7872 the note is worth its face amount at the time of issuance and no imputed interest results. Section 1274(d) provides the AFR for a debt instrument based on its term.[27] There are three AFRs for term debt instruments: (1) The federal short-term rate, which applies to terms of three years or less; (2) the federal mid-term rate, which applies to terms exceeding three years, but not exceeding nine years; and (3) the federal long-term rate, which applies to terms greater than nine years.

The November 2011 semi-annually compounded short-term, mid-term, and long-term AFRs were 0.19 percent, 1.20 percent, and 2.65 percent, respectively.[28] Section 1274(d)(2) further states that in any sale or exchange, the AFR shall be the "lowest 3-month rate."[29] The "lowest 3-month rate" is the lowest AFR for the three calendar month period ending with the first

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[22] IRC § 7872(f)(3).

[23] IRC. § 7872(c)(1)(C).

[24] IRC § 7872(c)(1)(B). See also Prop. Treas. Reg. § 1.7872-4(d)(2) (providing circumstances when such loans will be presumed to be considered corporate-shareholder loans, rather than compensation-related loans).

[25] IRC § 7872(c)(1)(D).

[26] IRC § 7872(c)(1)(E). See also Prop. Treas. Reg. § 1.7872-4(f) (reserving a portion of the proposed regulations to define significant-effect loans in the future).

[27] See generally IRC § 1274(d) (discussing how to determine the AFR).

[28] Rev. Rul. 2011-25, 2011-45 IRB 695, at Table 1.

[29] IRC § 1274(d)(2)(A).

calendar month in which there is a written binding contract for the sale or exchange.[30] The Staff of the Joint Committee on Taxation summarized the impact of Section 7872 perfectly when it stated, "[L]oans that are subject to [Section 7872] . . . are recharacterized as an arm's-length transaction in which the lender made a loan to the borrower in exchange for a note requiring the payment of interest at the [AFR]."[31]

***Planning Opportunity.*** In effect, Section 7872 applies only to below-market loans. By definition, loans at or above the AFR are not interest-free loans or below-market loans, and there is no taxable gift associated with a loan at the AFR. Thus, if a note bears at least the AFR at the time of its issuance, there is no gift tax liability on the part of the grantor and Section 7872 does not apply. The use of the AFR provides a substantial wealth transfer benefit to the grantor and his or her future generations as long as the return on investment of the IDGT's LP interest exceeds the ISPN's AFR. Assuming the IDGT obtained a return on investment greater than the ISPN's AFR, the IDGT repays the ISPN principal to the grantor at the end of the ISPN's term and retains the appreciated assets free of income, estate, gift, and GST taxes.[32]

## Using IDGTs, FLPs, and ISPNs for Estate Planning

EPs commonly form an IDGT and the grantor gifts $5 million ($10 million for split-gifts) to fund the IDGT. Prior to 2011, the lifetime gift tax exemption amount was $1 million. Currently, it is $5 million, but in 2013 it reverts to $1 million. Additionally, the lifetime estate and GST tax exemption amounts will be reduced to $1 million in 2013. Thus, grantors have only 2011 and 2012 to take advantage of the additional $4 million lifetime gift tax exemption amount. The grantor's $5 million gift exhausts the grantor's lifetime gift and GST tax exemption amounts.[33] Separately, the EP creates an FLP and the grantor contributes assets to the FLP in return for a 1 percent GP interest and a 99 percent LP interest. Due to the control and marketability restrictions placed in the FLP

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[30] IRC § 1274(d)(2)(B).

[31] Burke & Friel, supra note 19, at 853.

[32] Assuming the EP allocated GST exemption to the gift the grantor made to the IDGT. See the following section of this article for additional information relating to the use of IDGTs, FLPs, and ISPNs as estate planning wealth transfer vehicles.

[33] This is assuming the grantor has not previously used any of his or her lifetime gift or GST tax exemption amounts. A married grantor can make a split-gift with his or her spouse and gift up to $10 million assuming neither spouse has previously utilized his or her lifetime gift or GST tax exemption amounts. In the event that the grantor has used a portion of the lifetime gift tax or GST exemption amounts, a financial analysis will need to be completed comparing utilization of the grantor's remaining gift tax and GST exemption versus an amount that would result in a current gift tax.

partnership agreement, the grantor receives a valuation discount ranging from 25 percent to 50 percent.[34] These valuation discounts result in very large tax savings and beneficial wealth transfers for the grantor to his or her descendants especially in the current market of severely depressed asset values.

The grantor then enters into a sale of a portion of the LP interests with the IDGT and retains the GP interest and any unsold LP interests. In exchange for the LP interests, the grantor receives a cash down payment and an installment note[35] for the remaining value of the sold LP interests. Therefore, a portion but not all of the gifted $5 million of seed capital used to form and fund the IDGT is returned to the grantor.

*Caution:* The IDGT must not repay the entire amount gifted by the grantor to the IDGT because then the transaction would lack economic substance. That is because the IDGT would likely have insufficient liquid assets (i.e., cash) to make the required annual interest-only payments to the grantor. Conversely, if the purchased LP interest generates sufficient cash flow to satisfy the required annual interest-only payments to the grantor, then the entire gifted amount can be repaid to the grantor. Additionally, the grantor is required to charge interest on the ISPN at the respective AFR (which has historically been less than that charged by commercial lenders). Section 7872 is inapplicable because it applies only to below-market loans, and no gift is imputed to the IDGT beneficiaries if the correct AFR is charged on the ISPN based on the ISPN's corresponding term.

## Current Valuation Discounts for FLP LP Interests

EPs use FLPs for wealth transfer planning to generate a valuation discount for the underlying FLP assets based on the lack of marketability and control associated with the LP interest. As the use of FLPs increased, so did the IRS's attacks on FLP valuation discounts. However, the IRS has had only limited

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[34] See David T. Lewis & Andrea Chomakos, *The Family Limited Partnership Deskbook: Forming and Funding FLPs and Other Closely Held Business Entities* (2nd ed. 2007), at 15 (stating that FLP LP interests have received minority discounts ranging from 15 percent to 40 percent); Staff of Joint Comm. on Taxation, 109th Cong., 1st Sess., "Options to Improve Tax Compliance and Reform Tax Expenditures" (Jan. 27, 2005) (Comm. Print) (finding that FLP LP interests receive 20 percent to 30 percent marketability valuation discounts); Daniel L. Ricks, "I Dig It, But Congress Shouldn't Let Me: Closing the IDGT Loophole," 36 ACTEC L.J. 641, 652 (2010) (indicating the IRS accepts typical valuation discounts ranging from 25 percent to 40 percent).

[35] The promissory note is usually an installment note. See Zaritsky, supra note 14, at § 12.07 (discussing the advantages and disadvantages of selling assets to an IDGT in return for an installment note); Ricks, supra note 34, at 649-651.

success challenging FLP valuation discounts.[36] The estate and gift tax value of a donor's interest in an FLP is the fair market value (FMV) of the interest on the date of the transfer.[37] The FMV of the partnership interest is the price at which the interest "would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[38] The grantor's FLP interests gifted or sold should be valued (i.e., not the underlying FLP assets) because the FLP, not the grantor/seller, owns the underlying assets. In addition, the FLP partnership agreement includes control and marketability restrictions, which are the basis for the FLP interest valuation discounts.[39]

**Various IRS Challenges.** The IRS unsuccessfully began its war challenging FLP interest valuation discounts in the 1990s, initially arguing that FLPs should be ignored for tax purposes because FLPs lacked economic substance, were created without a valid business purpose, and were created for the sole purpose of obtaining valuation discounts for tax avoidance.[40] Second, the IRS argued, also without success, that the creation and funding of an FLP where valuation discounts are applied is a gift to the other partners at formation of the FLP.[41] Third, the IRS had limited success asserting Section 2703(a)(2), which provides that the value of property shall be determined without regard to "any restrictions on the right to sell or use *such property*."[42] Fourth, the IRS asserted Section 2704(b), again with minimal success. The IRS challenged transfers of an interest in a corporation or a partnership to or for the benefit of a member of the transferor's family, when the transferor and members of the

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[36] See John Bogdanski, *Federal Tax Valuation* (1996), at ¶ 6.03 (informing taxpayers that the IRS has had limited success in combating FLP LP interest valuation discounts); Laura E. Cunningham, "The FLP, the Transfer Taxes, and the Income Tax," Working Paper No. 297 (Apr. 2010) (discussing the successes and failures of the IRS challenging valuation discounts for FLPs).

[37] IRC § 2031 (estate tax); IRC § 2512 (gift tax); IRC § 2624 (GST tax). FMV is determined on the date of the gift in the case of the gift tax or on the date of the decedent's death (or on the alternative valuation date) if the executor elects in the case of the estate tax.

[38] Treas. Reg. §§ 20.2031-1(b), 25.2512-1.

[39] Zaritsky, supra note 14, at §10.02[1].

[40] See Tye J. Klooster, "Attacks on FLPS" (Katten Muchin Rosenman LLP, Chicago, Outline), at Part I.

[41] Id. The IRS's argument is based on the premise that if a partner transfers assets valued at, say, $1 million to an FLP and receives back an LP interest valued at $650,000, then the remaining $350,000 has been gifted to the other partners. Id.

[42] Id. IRC § 2703(b) provides an exception to IRC § 2703(a) if the agreement, right, or restriction is part of a bona fide business arrangement, and is not a device to transfer such property to the decedent's family for less than full and adequate consideration in money or money's worth. In addition, the terms must be comparable to similar arrangements entered into by persons in an arm's length transaction.

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transferor's family immediately before the transfer controlled the entity. As a result, any "applicable restriction" must be disregarded in determining the value of the transferred interest.[43]

Conversely, the IRS has successfully argued that gifts of LLC units were not present interests and therefore did not qualify for the gift tax annual exclusion under Section 2503(b). The Service argued that the applicability of the gift tax annual exclusion to a gift of LLC units properly focuses on the donees' right to immediate use of property and the donees' immediate right to income of property. A court held that an LLC operating agreement "foreclosed the ability of donees presently to access any substantial economic or financial benefit that might be represented by ownership interests."[44] On the other hand, several PLRs have held that gifts of FLP interests do qualify for the gift tax annual exclusion.[45] In order for gifts of LLC interests to qualify, the LLC operating agreement needs to be properly drafted to allow the donees of the LLC units to have a present interest in such units.

In addition, the IRS has successfully argued that a gift of the underlying assets and not the FLP interests had occurred because the donor simultaneously, or relatively shortly thereafter, contributed assets to an FLP and gifted FLP interests. The transfer of FLP interests is really a transfer of the underlying assets contributed to the FLP.[46] The IRS's preferred weapon of attack on FLPs is Section 2036. However, a donor will defeat the IRS's assertion of Section 2036 if the FLP interests are part of a bona fide sale for adequate and full consideration for money or money's worth.[47] In order to satisfy this exception, the donor must create the FLP as part of a "bona fide sale" and the

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[43] IRC § 2704(b). An "applicable restriction" refers to any restriction which effectively limits the ability of the corporation or partnership to liquidate, and with respect to which either of the following applies: (i) the restriction lapses, in whole or in part, after the transfer or (ii) the transferor or any member of the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction. Id. Treas. Reg. § 25.2704-2(b) provides a limitation not found in the text of the statute. The regulation provides that an "applicable restriction" is a limitation on the ability to liquidate the entity that is more restrictive than the limitations that would apply under default state law generally applicable to the entity in the absence of the restriction. Treas. Reg. § 25.2704-2(b).

[44] Hackl v. Comm'r, 118 TC 279, 296 (2002), aff'd, 335 F.3d 664, 668 (7th Cir. 2003).

[45] See generally PLR 9415007 (Jan. 13, 1994) (holding that the gifting of FLP LP interests can qualify for the gift tax annual exclusion).

[46] See Treas. Reg. § 25.2511-1(h)(1) (providing the IRS with support for its indirect gift argument). The regulation provides that if a shareholder transfers property to a corporation for less than full and adequate consideration in money or money's worth, the transferor has made a gift to the other shareholders to the extent of their proportionate interest in the corporation. Id. The impact of this argument is that the gift of the underlying assets does not get a valuation discount while the gift of an LP interest receives a valuation discount because of lack of control and marketability.

[47] IRC § 2036.

transfer to the FLP must have been for "adequate and full consideration for money or money's worth."[48]

**Impact of Possible Legislation.** Currently, no bills in Congress would eliminate FLP valuation discounts. However, President Obama's 2012 Budget Proposal includes two provisions that would affect such discounts: (1) requiring consistency in value for transfer and income tax purposes; and (2) modifying the IRC regarding transfer tax valuation discounts by disregarding restrictions in the FLP agreement when valuing an interest in a family-controlled entity that is transferred to another member in the family. Earlier legislation dealing with valuation discounts had gone nowhere. In 2009, North Dakota Representative Earl Pomery introduced H.R. 436,[49] "Certain Estate Tax Relief Act of 2009." Had H.R. 436 been enacted, it would have statutorily superseded Revenue Ruling 93-12 and all prior case law.[50] Specifically regarding FLP valuation discounts, H.R. 436 would have disallowed taxpayers a valuation discount on "nonbusiness assets" held by a partnership, including any asset not used in the active conduct of one or more trades or businesses. Instead, those assets would have been valued as if owned directly and transferred to the recipients. In addition, H.R. 436 would have eliminated all valuation discounts for FLPs when the transferee's family controls the FLP and "nonbusiness assets."

**Window of Opportunity is Limited.** After more than two decades of attacks by the IRS, failed congressional bills, and proposed legislation in President Obama's 2012 Budget, it is certain the federal government will continue to challenge FLP interest valuation discounts. Grantors must take advantage of the FLP interest valuation discounts immediately before they are eliminated.

## Tax Implications of Substituting an ISPN Between an IDGT and its Grantor

The tax implications of substituting a matured ISPN that cannot be repaid by the IDGT are drastically different from an unmatured ISPN that the grantor solely wishes to substitute with a new ISPN to take advantage of the current lower AFR compared to the original ISPN's higher stated AFR.[51] This article

[48] Estate of Bongard v. Comm'r, 124 TC 95, 114 (2005).

[49] H.R. 436, 111th Cong. (2009).

[50] See Rev. Rul. 93-12, 1993-1 CB 202 (stating the IRS would abandon family attribution rules regarding FLP valuation discount attacks).

[51] See generally David A. Handler & Deborah V. Dunn, *Drafting the Estate Plan: Law and Forms* (2007), at § 11.07[E] (discussing how a grantor can refinance an original ISPN at a higher AFR with a new ISPN at the lower current AFR).

concentrates on the unmatured ISPN situation. The tax implications may differ depending on how the ISPN is substituted. EPs have advocated several note substitution options, although it is unsettled whether all the options result in nontaxable exchanges. Two substitution options advanced by EPs are analyzed below: (1) repayment of the original ISPN and outstanding interest with subsequent issuance of a new ISPN and (2) substitution of the original ISPN with a new ISPN at the current AFR.

**Repayment of Original ISPN Principal and Outstanding Interest With New ISPN at Current Lower AFR.** The IDGT can repay the original ISPN and outstanding interest in one of the following ways.

***Repay With Own Funds.*** First, the IDGT can simply pay off the original higher AFR ISPN and the outstanding interest and borrow again at the current lower AFR from the grantor if, and only if, the original ISPN had a prepayment clause.[52] No income tax implications result from this transaction. Per Section 61(a)(4), normally a lender recognizes interest income to the extent of the interest paid by the borrower, and the borrower recognizes interest expense, per Section 163(a). However, the IDGT and the grantor are deemed to be the same for income tax purposes, and the net effect of the interest income and interest expense is zero. Alternatively, a gift tax may result if the original ISPN's accrued interest is not repaid by the borrower to the lender.[53] This option is highly unlikely because the IDGT will not, and should not, have sufficient cash or other liquid assets to repay the original note.[54]

***Use Third-Party Loan Funds***. Second, an IDGT with insufficient cash to repay the original ISPN may obtain a loan from a third-party lender, repay the original note with the third-party proceeds, and then speculate that the grantor will lend the IDGT funds with a new ISPN at the lower AFR to repay

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[52] Blattmachr et al., supra note 8, at 26.

[53] If the total unpaid accrued interest exceeds the aggregate annual gift tax exclusion amount of all the IDGT beneficiaries or if used in other planning during the year (see generally IRC § 2503(b)), then a gift tax will result since the grantor already fully used his or her $5 million gift tax exemption upon funding the IDGT. See supra text accompanying notes 33-37 (explaining that the grantors fully utilized their gift tax exemption when they funded their IDGT with their $5 million gift).

[54] Because the IDGT owns the LP interests of the FLP, it is highly unlikely that the IDGT will have enough cash to repay the original ISPN. The LP interests are illiquid (precisely the reason why the LP interest received the valuation discounts in the first place). Furthermore, if the IDGT did have sufficient cash to repay the original ISPN, the grantor should fire the investment manager—this would indicate that the investment manager is not investing the IDGT assets to obtain a maximum or even adequate return on investment to exceed the required interest to be paid to the grantor based on the ISPN's AFR.

the third-party lender.[55] This approach is also unlikely because of the additional transaction costs incurred in obtaining third-party financing, usually at a higher interest rate than the current AFR and loan origination fees.[56] In addition, the IRS may successfully argue that the step-transaction doctrine applies and disregard the third-party lender financing portion of the ISPN substitution,[57] thus treating the transaction as if the grantor and IDGT substituted the original ISPN (with higher AFR) for the new ISPN (with lower

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[55] Benjamin N. Feder, "The Promissory Note Problem," 142 Tr. & Est. 10, 11 (Jan. 2003).

[56] Generally the AFR rate is lower than any rate available from third-party lenders. However, instances may exist where the original ISPN AFR rate exceeds the third-party lender interest rate, but loan origination fees diminish the interest savings benefit.

[57] The step-transaction doctrine requires the interrelated steps of an integrated transaction to be taken as a whole rather than treated separately. There are three general variations (tests) of the doctrine: (1) binding commitment, (2) interdependence, and (3) end result. Under the binding-commitment test, transactions are treated as steps of a single transaction if the parties were legally obligated to complete all of the transactions. Comm'r v. Gordon, 391 U.S. 83 (1968). This variation is most often applied when the taxpayer seeks to invoke the step-transaction doctrine. When the government seeks to invoke the doctrine, the analysis rarely stops with a failure to meet the binding commitment test. Id. The interdependence test is met if the steps were "so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." Manhattan Bldg. Co. v. Comm'r, 27 TC 1032, 1042 (1957). See Kornfeld v. Comm'r, 137 F3d 1231 (10th Cir.), cert. denied, 525 U.S. 872 (1992) (applying this test to step together gift of cash from father to daughter followed by simultaneous purchase by father of life estate and daughter of remainder interest in bonds pursuant to a tax-avoidance scheme). The end-result test amalgamates into a single transaction the separate events that were intended from the outset to be component parts of reaching a particular result. Id.

In addition, the courts (particularly the Tax Court) often decline to apply the step-transaction doctrine if the taxpayer structures a series of transactions to take advantage of a favorable tax provision, as long as each step has colorable independent economic substance and business purpose. See Esmark, Inc. v. Comm'r, 90 TC 171 (1988), aff'd by order, 886 F2d 1318 (7th Cir. 1989) (rejecting the IRS's claim that the step-transaction doctrine should apply to recast the taxpayer's distribution, which was in essence the sale of appreciated stock of a subsidiary, in order to take advantage of the pre-1986 *General Utilities* doctrine as a sale). Furthermore, the courts are also reluctant to apply the step-transaction doctrine where there is no indication that the taxpayer sought to obtain a tax advantage by adding meaningless steps to a transaction with a bona fide business purpose. In such a case, the form and substance of the transaction will be found to coalesce, particularly where the IRS's recast version of the transaction fails to account for aspects of the transaction that actually occurred or requires the insertion of a hypothetical transaction that never occurred. See Turner Broad. Sys. v. Comm'r, 111 TC 315 (1998) (discussing a taxpayer that made mutually dependent sales of stock in certain corporations to facilitate the acquisition of one subsidiary by another corporation without the acquisition of the subsidiary's subsidiary; court declined to recast the sales as a constructive contribution of capital to one corporation followed by a redemption). Finally, Congress has codified portions of the step-transaction doctrine, e.g., IRC § 302(b)(2)(D), so it must be apparent to it that application of the step-transaction doctrine is better placed in the hands of the judiciary than that of the legislature.

AFR), causing a gift tax effect attributable to the difference between the higher and lower AFRs.

***Use Non-Cash Assets.*** Third, a borrower without adequate cash or the ability to obtain third-party financing may use non-cash assets to repay the original ISPN and outstanding interest. Thereafter, the grantor can make a new loan to the IDGT at the lower AFR. A borrower's use of non-cash assets will result in recognition of gain if the FMV of the non-cash assets exceeds the borrower's adjusted basis in the non-cash assets.[58] Conversely, gain is not recognized when another provision of the tax law would prevent recognition of gain or if the lender and borrower are treated as the same taxpayer.[59] Therefore, since the IDGT and grantor are the same for income tax purposes, no recognition of gain or loss results. Furthermore, the transfer of non-cash assets back to the grantor undermines the purpose of the grantor's overall EP plan because the non-cash assets are included in the grantor's gross taxable estate and cannot appreciate free of estate and GST tax for future generations outside the grantor's taxable estate.

In theory, the above three mentioned options work, but in practice they do not because of the associated costs and potential audit risk.

**Substitution of a New Lower-AFR ISPN for Original Higher-AFR ISPN.** Some EPs advise that the IDGT may also issue a new ISPN at the current lower AFR and substitute this new note for the original higher-AFR ISPN without an adverse tax effect, as long as the original ISPN permits prepayment at any time.[60] Conversely, other EPs advocate that to avoid a gift tax additional steps must be taken to justify charging a lower, current AFR on the new ISPN.[61] Such steps include one or more of the following: a decrease

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[58] For example, take a borrower with an original ISPN with combined principal and accrued interest totaling $45 million. In addition, the borrower has non-cash assets (i.e., land or securities) with a FMV of $45 million and an income tax adjusted basis in the hands of the borrower totaling $30 million. The borrower will recognize $15 million (i.e., $45 million - $30 million) for income tax purposes when the borrower satisfies the original ISPN with the non-cash assets. See generally IRC § 1001 (describing how to compute gain or loss on the sale or other disposition of property); IRC § 1011 (specifying the adjusted basis to use to determine gain or loss); IRC § 1012 (stating that the basis of property is the cost of such property); IRC § 1014 (determining the basis of property acquired from a decedent); IRC § 1015 (informing how to determine the basis of property acquired by gifts and transfers in trust); IRC § 1016 (stating what adjusts the basis of property).

[59] Rev. Rul. 85-13, supra note 9. For example, a transaction between a grantor and IDGT is disregarded for income tax purposes because the grantor and IDGT are considered the same taxpayer. See also IRC § 1041 (stating transfers of assets between spouses generally do not result in gain or loss).

[60] Blattmachr et al., supra note 8, at 26.

[61] See generally Feder, supra note 55 (discussing various options for grantors to substitute an original higher-AFR ISPN for a new ISPN with a currently lower AFR).

in the term, reduction of principal, providing additional collateral, and/or issuing two new ISPNs in place of the original ISPN with different terms.[62] Again, the IRS may assert the step- and sham-transaction doctrines, contending that the lender merely accepted a new lower-AFR ISPN for the original higher-AFR note solely to avoid tax.[63] Therefore, the tax implications of the grantor cancelling the original higher-AFR ISPN in lieu of a new lower-AFR ISPN must be assessed to determine if a gift tax event occurs. Even though no case law, statute, regulation, or ruling expressly provides that ISPNs may be substituted without gift tax effects, EPs argue that the IRC and regulations can be interpreted to support such result.

**Gift Tax Effects of ISPN Substitution.** For gift tax purposes, it is undisputed that, when two assets with varying FMVs are exchanged, a gift may result.[64] If the FMVs of the new ISPN and the original ISPN are equal, however, no gift results. Accordingly, the FMV of each nonmarketable ISPN must be determined. Moreover, if the FMV of both nonmarketable ISPNs at time of exchange are equivalent then the grantor cannot incur a gift or gift tax.

***Determining Fair Market Value of Nonmarketable ISPNs for Gift Tax Purposes.*** Determining whether a gift tax results from trading two marketable ISPNs is simple because the exchange on which the ISPNs are traded provides their trading prices (i.e., their FMVs).[65] If the FMVs of the two notes are equal, then no gift tax results. However, if the FMVs differ, then a gift tax measured by the difference between the FMVs of the ISPNs that exceeds the unused annual gift tax exclusion amount results. But other valuation methods must be used to determine the FMV of nonmarketable ISPNs.

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[62] Id.

[63] Courts apply the sham transaction doctrine to deny tax advantages to transactions that lack economic substance. The Tax Court favors a one-prong test to determine if a sham transaction exists. The Tax Court will not normally treat a transaction as a sham if it has economic substance, "even in the absence of a nontax business purpose." Saba P'ship v. Comm'r, TC Memo 1999-359, vacated and remanded, 273 F3d 1135 (DC Cir. 2001), on remand, TC Memo. 2003-31. Other courts utilize a two-prong test. The first prong of the inquiry examines whether the transaction has economic substance other than the creation of a tax benefit, which has been labeled the "objective" economic substance test. The second prong examines whether the transaction was motivated by any business purpose other than obtaining a tax benefit, which has been labeled the "subjective" business purpose test.

[64] IRC § 2512(b).

[65] Blattmachr et al., supra note 8, at 27. See also Treas. Reg. § 25.2512-2(a) (providing that the FMV of a security, including a bond traded on an exchange, is determined by the trading price of the security on the principal exchange on which the security is traded).

EPs argue that the FMV of the original higher-AFR ISPN is the same as the new lower-AFR ISPN.[66] Section 7872(h) may authorize gift tax regulations concerning the valuation of intrafamilial loans charging interest at the AFR. To date, no such regulations have been issued, but regulations for estate tax purposes have been issued.[67] It is likely that family ISPNs will be valued for gift tax purposes in accordance with Treasury Regulation Section 25.2512-4,[68] which states in pertinent part:

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus accrued interest to the date of the gift, unless the donor establishes a lower value. Unless returned at face value, plus accrued interest, it must be shown by satisfactory evidence that the note is worth less than the unpaid amount (because of the interest rate, or date of maturity, or other cause), or that the note is uncollectible in part (by reason of the insolvency of the party or parties liable, or for other cause), and that the property, if any, pledged or mortgaged as security is insufficient to satisfy it.[69]

In addition, Proposed Treasury Regulation Section 25.2512-4, issued in conjunction with proposed regulations under Section 7872, further supports the notion that Treasury Regulation Section 25.2512-4 must be used to value an already issued ISPN where the ISPN is considered a gift. The final sentence of the proposed regulation states, "See § 25.7872-1 for special rules in the case of gift loans (within the meaning of § 1.7872-4(b)) made after June 6, 1984."[70] The Treasury's reference to Section 7872 seems to indicate that the valuation of nonmarketable ISPNs is determined under Section 2512 except to the extent that the final regulations under Section 7872 indicate otherwise.

Assuming Proposed Treasury Regulation Section 25.7872-1 is finalized, it appears to provide a valuation rule for term loans only when the ISPN is made, not upon subsequent transfers.[71] Furthermore, the proposed regulation's heading, "Below-Market Loans," indicates that it applies only to

[66] Blattmachr et al., supra note 8, at 27. See also Feder, supra note 55, at 11 (presenting three scenarios to refinance an original ISPN with a higher AFR for a new ISPN with a lower AFR); Steve Leimberg, Steve Leimberg's Estate Planning Newsletter: Interesting Interest Rate Questions, LISI Estate Planning Newsletter # 1447 (Apr. 16, 2009) (discussing the tax implications that result when the interest rate on an existing loan is reduced).

[67] Blattmachr et al., supra note 8, at 27.

[68] Id. at 28.

[69] Treas. Reg. § 25.2512-4.

[70] Prop. Treas. Reg. § 25.2512-4.

[71] Prop. Treas. Reg. § 25.7872-1.

below-market loans, and an ISPN charging interest at least equal to the AFR is by definition not considered a below-market loan.[72]

***ISPNs With Differing AFRs But the Same Face Value Are Worth the Same.*** Now that the valuation of gift ISPNs at formation has been determined for gift tax purposes, the valuation of these ISPNs at transfer must also be determined, specifically ISPNs with differing AFRs. EPs argue that Treasury Regulation Section 25.2512-4, which determines the FMV of a nonmarketable ISPN, presumes the note has a FMV equal to its face amount, and, more important, the regulation seems to allow a variation of value only to establish that the ISPN is worth less than the face amount, not more.[73] An ISPN should not be treated as having a FMV for gift tax purposes greater than its face value. Proposed estate tax regulations support that conclusion. Proposed Treasury Regulation Section 20.7872-1 states, in pertinent part:

> For purposes of chapter 11 of the Internal Revenue Code, relating to estate tax, a gift term loan (within the meaning of §1.7872-4(b)) that is made after June 6, 1984, shall be valued at the lesser of:
> (a) The unpaid stated principal, plus accrued interest; or
> (b) The sum of the present value of all payments due under the note (including accrual interest), using the applicable Federal rate for loans of a term equal to the remaining term of the loan in effect at the date of death.[74]

Furthermore, the Preamble to Proposed Treasury Regulation Section 1.7872 states, "In addition, proposed § 20.7872-1 implements section 7872(g)(2) [now (i)(2)] by prohibiting the discounting, at other than the applicable Federal rate, for estate tax purposes, of any term loan made by a decedent with donative intent after June 6, 1984." Therefore, the ISPN cannot be valued at greater than its face amount plus accrued interest at formation.

As previously discussed, the gift tax proposed regulations do not contain any valuation rules for notes after issuance. The only reference to gift taxation in the Preamble to Proposed Treasury Regulation Section 1.7872 is that "Proposed § 25.7872-1 implements IRC section 7872(a) by providing that the amount transferred by the lender to the borrower and characterized as a gift is subject to the gift tax provisions." Accordingly, the valuation of an ISPN after issuance is determined by Treasury Regulation Section 25.2512-4, which also provides that an ISPN's value does not exceed its face amount plus accrued interest whether a prepayment penalty exists or not. It is therefore probable that

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[72] Blattmachr et al., supra note 8, at 28.

[73] Id.

[74] Prop. Treas. Reg. § 20.7872-1.

an original ISPN issued with an AFR exceeding a new ISPN with the current lower AFR has a FMV for gift tax purposes not exceeding the original note's face value. Furthermore, Section 7872 values an ISPN that bears the current AFR at issuance equal to the ISPN's face value for gift tax purposes. Based upon the application of Treasury Regulation Section 25.2512-4 and Code Section 7872, the original ISPN subject to an AFR higher than the current AFR and a new ISPN subject to that lower AFR should be treated as having the same FMV for gift tax purposes at substitution. Accordingly, the substitution is merely an exchange of property with equal values, with no gift tax.

**Income Tax Effect of ISPN Substitution.** Section 1001 determines whether a taxpayer realizes gain or loss on the sale or other disposition of property. Gain is the excess of the amount realized over the taxpayer's adjusted basis,[75] and loss is the excess of the taxpayer's adjusted basis for determining loss over the amount realized.[76] Usually, the amount realized from the sale or other disposition of property is the sum of any money received plus the FMV of the property (other than money) received.[77] The realized gain is fully recognized unless a nonrecognition provision applies.

Per Treasury Regulation Section 1.1001-1(a), "The gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained."[78] Treasury Regulation Section 1.1001-3(b) indicates that a taxpayer may realize gain or loss even without an actual exchange of property for other property if a debt instriment is significantly modified.[79] And Treasury Regulation Section 1.1001-3 provides that a change in interest rates of a debt instrument can qualify as a significant modification.[80] Therefore, the exchange of a new lower-AFR ISPN for an original higher-AFR ISPN can result in a realization event under Section 1001 for the transferring parties. However, because the grantor and the IDGT are treated for income

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[75] IRC § 1001(a).

[76] Id.

[77] IRC § 1001(b).

[78] Treas. Reg. § 1.1001-1(a).

[79] See Treas. Reg. § 1.1001-3 (explaining the income tax implications of modifications of debt instruments).

[80] Id. See also Rev. Rul. 89-122, 1989-2 CB 200 (holding that the reduction in the interest rate of an ISPN is a material modification that results in a taxable exchange of debt instruments under IRC § 1001); Rev. Rul. 87-19, 1987-1 CB 249 (stating that a taxpayer's waiver of its right under the interest adjustment clause in an ISPN to receive a higher rate of interest results in a material change in the terms of the bonds and, therefore, is deemed an exchange under IRC § 1001 of the old bonds for new bonds); PLR 9127003 (Mar. 18, 1991) (concluding that a change of interest rates on obligations constitutes a material modification that causes the obligations to be reissued for purposes of IRC § 265(b)).

tax purposes as one and the same, the substitution of the original higher-AFR ISPN for a new lower-AFR ISPN should not result in recognition of gain or loss for income tax purposes. EPs zealously advocate that the substitution of a new ISPN with a lower AFR for the original higher-AFR ISPN results in neither an income tax nor gift tax for the grantor and IDGT.

## Recommendations for Current Practice

Favorable interest rates; depressed asset values; the $5 million life-time gift, estate, and GST tax exemption amounts; and a potentially limited time-frame to continue receiving FLP interest valuation discounts create a perfect economic environment for EPs to help clients establish wealth transfer plans or to reassess existing wealth transfer plans.[81] This section suggests two planning scenarios: one for an individual who is seeking for the first time to create a wealth transfer plan consisting of an IDGT, FLP, and ISPN between the grantor and IDGT and one for a grantor who already has such a wealth transfer vehicle in place, but desires to take advantage of the current lower AFRs.

**Scenario #1: Creating a New Wealth Transfer Plan Consisting of an IDGT, FLP, and ISPN Between Grantor and IDGT.** EPs agree there is no better time than now for grantors to develop a highly advantageous wealth transfer plan, but time may quickly expire because the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[82] (the TRUIRJCA) will soon sunset, and a comprehensive tax increase agenda may ensue. With interest rates and particularly the AFR at all-time lows, it is only logical that interest rates will increase in the coming years.

EPs do not agree on the term that should be used when initially designing a wealth transfer vehicle consisting of an IDGT, FLP, and ISPN at the current AFR between grantor and IDGT. Currently, most EPs are using the mid-term rate. However, the November 2011 semi-annually compounded

[81] See generally Steve Leimberg, Steve Leimberg's Estate Planning Newsletter: The Estate Planning Triple Witching Hour is Upon Us!, LISI Estate Planning Newsletter # 1445 (Apr. 14, 2009) (informing taxpayers that any time interest rates decrease, asset values become depressed, or valuation discounts are available, tax benefits are available; when all three are available at the same time (as currently they are) taxpayers are in a better position than ever); Norvell E. Brasch & John R. Valentine, "Darkening Cloud for Discounts May Have a Silver Lining: Opportunity to Transfer Wealth at Historically Depressed Values Before Congress Moves to Restrict Family Entity Discounts," Jan. 30, 2009, available at http://www.hro.com/files/file/publications/ALERT-DarkeningCloud.pdf (last visited Nov. 27, 2009) (discussing how the IRS's unfettered attack on valuation discounts and the introduction of H.R. 436 could have eliminated valuation discounts for FLP interests, therefore, now is the best time to take advantage of FLPs and valuation discounts).

[82] P.L. 111-312, 124 Stat. 3296.

short-term rate is 0.19 percent and mid-term rate is 1.20 percent—this spread makes the short-term rate 632 percent less.[83] Thus, as of this writing, using the short-term rate for an ISPN between the grantor and IDGT would result in substantial tax savings and additional wealth transfer for the grantor, as illustrated in the following examples.

> ***Example 1:*** Assume a grantor sells his or her IDGT FLP LP interests with a FMV of $50 million in exchange for $5 million in cash and a $45 million ISPN with an AFR at the November 2011 semi-annually compounded short-term rate of 0.19 percent and with a term not exceeding three years.[84] The IDGT is required to pay the grantor annual interest of $85,544 and total interest of $256,632 ($85,544 (annual interest) × 3 (term of ISPN) = $256,632).

> ***Example 2:*** In contrast, assume the same terms as in Example 1, except that the ISPN charges the November semi-annually compounded mid-term rate of 1.20 percent. Now, the IDGT is required to pay the grantor annual interest of $541,620 and total interest of $1,624,860 ($541,620 (annual interest) × 3 (term of ISPN) = $1,624,860). Thus, an ISPN with an AFR of the short-term rate with the same principal and term as an ISPN with the mid-term rate results in interest payments totaling $1,368,228 less than when using the mid-term rate ($1,624,860 (total interest payments with the mid-term rate) - $256,632 (total interest payments with the short-term rate) = $1,368,228).

As the examples show, applying the 2011 highest estate tax rate of 35 percent results in an estate tax saving of $478,880 ($1,368,228 × .35 = $478,880) when using the semi-annually compounded short-term rate rather than the mid-term rate. The use of the semi-annually compounded short-term rate results in the grantor's estate increasing by less than if the mid-term rate were used, and the grantor pays less estate tax. This difference will be even more crucial when the estate tax rate reverts to 55 percent in 2013.

The higher the AFR, the greater the IDGT's annual interest payment to the grantor. This has no income tax or gift tax effect, but there is a detrimental

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[83] Rev. Rul. 2011-25, supra note 28, at Table 1. The difference between the November 2011 semi-annually compounded short-term rate and mid-term rate is calculated as follows: 1.20% - .19% = 1.01%. The short-term rate as a percentage of the mid-term rate is calculated as follows: 0.012 ÷ 0.0019 = 6.32.

[84] See supra text accompanying notes 33-37 (explaining why the IDGT gives $5 million and a ISPN to the grantor in exchange for the FLP LP interests).

estate tax result.[85] In turn, the IDGT corpus decreases when the annual interest payable to the grantor exceeds the IDGT income. In addition, the grantor's estate increases by the amount of the interest payments from the IDGT: unless the grantor spends the additional interest income on services or assets that diminish in value prior to the grantor's death, the grantor's estate will increase in size by the interest amount or the value of the assets purchased with the interest income.[86] The lower the AFR on the ISPN between the grantor and IDGT, the less the grantor's estate will increase and the lower the grantor's potential estate tax liability.

Although it is certain that interest rates will increase over time, the short-term rate is always lower than the mid-term rate, and thus it is logical that EPs should use the short-term rate when drafting an ISPN between a grantor and IDGT. The short-term rate would have to increase to more than 632 percent of the present rate within the next nine years to reverse the resulting estate tax savings from using the short-term rate. An EP can therefore draft an ISPN with a term not exceeding three years, charging the short-term rate, then at maturity execute a second ISPN with a term not exceeding three years (Years 4 through 6), charging the then current short-term rate, and at maturity execute a final ISPN with a term not exceeding three years (Years 7 through 9), charging the then current short-term rate. This provides the grantor an estate tax savings, as long as the effective short-term rate over the nine-year term does not increase to more than 632 percent of the mid-term rate on the date the first note was executed.

In light of the above, why do EPs use the mid-term rate and not the short-term rate? They are being cautious. If EPs use three consecutive three-year term ISPNs, the IRS could argue that the step- and sham-transaction doctrines apply and collapse the three notes into a single nine-year term ISPN that applies the mid-term rate and which will trigger a gift tax liability based on the difference in the short-term and long-term rates. As noted above, Section 1274(d) requires that the short-term rate apply to ISPNs with a term equal to or less than three years and the mid-term rate apply to those with a term greater than three years, but not exceeding nine years. In making the argument that there is really only a single nine-year ISPN, the IRS would point out that the three consecutive three-year ISPNs charged only the short-term rate, and argue that Section 7872 requires the taxpayer to recognize a gift totaling the difference between the short-term rate charged on the notes and the mid-term rate that should have been charged on a nine-year note. In

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[85] This assumes the grantor has an estate exceeding the estate tax exemption amount and the grantor's spouse will fully utilize his or her estate tax exemption (currently $5 million for 2011 and 2012). IRC § 2010(c).

[86] The grantor cannot gift the required interest income from the IDGT or assets purchased with the interest income without incurring a gift tax liability because the grantor already used up the $5 million gift tax exemption when transferring the $5 million to the IDGT. See supra text accompanying notes 33-37.

addition, because the grantor would have fully used his or her $5 million lifetime gift tax exemption amount when funding the IDGT, an immediate gift tax liability would result rather than a deferred estate tax upon the grantor's death. Moreover, if the IRS's argument were successful, the grantor would be subject to a gift tax based upon the mid-term rate. Therefore, EPs should advise grantors to select a ISPN with a term that does not exceed nine years at the mid-term rate to avoid the possibility of a current gift tax liability in exchange for a deferred estate tax liability upon the grantor's death.

**Scenario #2: Substituting a New Lower-AFR ISPN for an Original Higher-AFR ISPN Without Creating Tax Liability.** Scenario #2 is as follows: A grantor who already has a wealth transfer plan in place that consists of an IDGT, FLP, and ISPN between the grantor and IDGT wants to substitute the note to take advantage of current lower AFR rates. This scenario assumes that the original ISPN has *not* matured, and the EP's overall objective is to minimize the grantor's estate tax. I propose a more conservative approach than the more aggressive substitution strategy discussed earlier. Instead of the grantor and IDGT substituting the original high-AFR ISPN for a new one with a lower AFR, the grantor should enter into an exchange or other sale of property with a third-party institution or intermediary. Assuming a grantor has a $45 million ISPN at the mid-term rate with a term not exceeding nine years, the grantor can either sell the ISPN to a third party for $45 million or less, or sell the ISPN to a third party in exchange for another ISPN at the current lower AFR.

In the event of an outright sale to the third party, the grantor recognizes any income or loss; the transaction is arm's length and between unrelated parties. However, under Section 1001, the grantor would not realize any gain because the amount received would equal his or her basis in the original ISPN.[87] Although the grantor's estate has increased by $45 million, the same result would have occurred upon the IDGT repaying the ISPN to the grantor at maturity. However, the grantor's overall estate will be smaller under this scenario than if the IDGT made the annual interest payments and repaid the note at maturity.[88] Therefore, it would be in the grantor's best interest to sell his or her ISPN to a third party to minimize overall estate tax liability.

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[87] IRC §§ 1001(a)-(b). The grantor's basis is $45 million and the sale price is $45 million; thus no gain is realized nor recognized.

[88] For instance, if the remaining term of the ISPN that the grantor sold was five years, the grantor would receive interest payments for five more years and increase his or her estate by the total of these interest payments. However, when the grantor sells the ISPN the grantor no longer receives any additional interest, resulting in a smaller estate and lower estate tax liability. In addition, the grantor will realize the money earlier and have a greater opportunity to spend it prior to his or her death, further decreasing the estate and the estate tax liability upon death.

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Alternatively, the grantor may enter into an exchange of property with the third party, transferring the original higher-AFR ISPN for a new ISPN at the current lower AFR. In this variation, the grantor has two options:

- *Option 1:* Exchange the original ISPN for a new ISPN with a term equal to the remaining term of the original ISPN at the current AFR, or
- *Option 2:* Enter into a new ISPN with a term of three years or less to take advantage of the short-term rate.

Under both Options 1 and 2, the grantor receives interest income from the third party correlative to the ISPN's AFR, but also incurs an interest expense exceeding the grantor's interest income from the third party.[89] Assuming that the grantor has sufficient net investment income to offset the grantor's interest expense, the grantor is not only decreasing his or her income tax liability, but is also decreasing his or her overall estate and thus estate tax liability.[90] However, there is a cost for this added benefit: the IDGT corpus is decreasing, because interest payments must be made to the third party at the higher original ISPN AFR. As a result, the IDGT has fewer trust assets to grow free of estate and GST tax, assuming the GST exemption was allocated to the grantor's $5 million gift to the IDGT. Conversely, the grantor receives principal repayment earlier than under the original ISPN so he or she is willing to receive a new ISPN with a lower AFR in its place.[91] The grantor continues to receive an interest expense deduction equal to the interest payment made by the IDGT to the third party, and the grantor's income tax liability decreases.

Under Option 1, the grantor exchanges his or her original ISPN for a new ISPN with a term equal to the remaining term of the original ISPN and with an AFR determined by the term of the new ISPN. Thereafter, the grantor receives interest payments from the third party commensurate with the AFR on the new ISPN and includes that amount as interest income. On the other

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[89] Because the grantor and IDGT are deemed the same for income tax purposes even though the IDGT is paying the third party interest on the ISPN that the grantor sold the third party, the grantor receives an interest expense deduction for the interest paid to the third party by the IDGT. In addition, the short-term, mid-term, and long-term rates will be lower on the new ISPN than the original ISPN; otherwise the grantor would not be entering into such a transaction. As a caveat, the grantor can offset his or her interest expenses only up to the extent of net investment income, and carry forward any excess interest expense. See IRC § 163(d) (discussing a taxpayer's ability to deduct investment interest to the extent of net investment income).

[90] IRC § 163(d)(4).

[91] This transaction is no different from what happens every day in the business world. Take for instance businesses that sell their accounts receivable or notes/loans receivable (e.g., car manufacturers, mortgagees, or retail stores). These businesses are willing to receive less than the total value of their receivables in return for cash today (or earlier than under the terms of their notes) in turn for the purchaser bearing their customers' default risk.

hand, the IDGT continues to make interest payments to the third party based on the original ISPN's AFR, resulting in a corresponding interest expense for the grantor. Upon maturity of the notes, the grantor receives a payment from the third party equal to the ISPN's face value and the third party receives a payment from the IDGT equal to the original ISPN's face value.

Under Option 2, the grantor exchanges the original ISPN for a new ISPN with a term not exceeding three years and an AFR equal to the short-term rate whether or not the remaining term of the original ISPN exceeds three years. The resulting tax effects are the same as for Option 1. However, Option 2 would result in less total interest income to the grantor, and thus a smaller taxable estate.

The IRS may argue the sham-transaction doctrine applies, claiming that the grantor's use of a third party has no economic substance other than tax avoidance. The IRS may also argue the step-transaction doctrine applies; the third party never existed; and the grantor merely substituted the original higher-AFR ISPN for a new lower-AFR ISPN. But such arguments would fail for several reasons:

1. The grantor enters into an arm's length transaction with an unrelated third party, who gives economic substance to the transaction.
2. The grantor actually incurs interest income from entering into the transaction, something that does not occur when the grantor holds the IDGT's ISPN. If the IRS successfully collapses the transaction, the grantor reduces his or her taxable income by the interest income received from the third party and reduces his or her interest expense by the amount paid to the third party.
3. The grantor can argue that he or she is accepting a new ISPN with a lower interest rate because the grantor's default risk is shifted to the third party.

Essentially, then, Option 2 allows the grantor to shift the risk of the IDGT defaulting on the original ISPN from the grantor to the third party. The third party bears the grantor's default risk because the third party is required to pay the grantor's new ISPN even if the IDGT defaults on its payment to the third party.

**Why Would a Third Party Be Interested?** Third parties would be interested in this arrangement for the following reasons:

1. To generate positive cash flow;
2. To decrease income taxes by utilizing suspended investment interest expenses; and
3. To decrease income taxes by offsetting nonpassive losses.

Until third parties learn of the opportunity to enter into such a transaction and its benefits, however, grantors and IDGTs will find it difficult to find willing third parties. But this transaction is based on the same premise that allows countless industries to thrive. For instance, banks lend money at a higher interest rate than they pay to individuals who deposit funds with them and factors purchase accounts receivable from businesses for less than the total value of the accounts receivable. Only time will tell how large the spread between the original higher-AFR ISPN and the new lower AFR ISPN needs to be before third parties are attracted to such a transaction. Although there are increased transaction costs associated with this option, the grantor and IDGT obtain significant audit defenses as a result of an arm's length transaction with a third party. Again, only time—and the free market—will tell how large an interest rate spread third parties will require before entertaining such a transaction.

**Deciding How to Proceed.** Considering the above, the grantor's alternatives for the best tax advantages are (listed in order of priority):

1. Substitution by the grantor of his or her original higher-AFR ISPN for a new lower current-AFR ISPN;
2. Grantor's outright sale of his or her original higher-AFR ISPN to a third party;
3. Exchange of the grantor's original ISPN for a new ISPN with a term not exceeding three years at the short-term rate; and
4. Exchange of the grantor's original ISPN for a new ISPN with a term equal to the remaining term of the original ISPN at the respective AFR.

## Conclusion

Although IDGTs, FLPs, and ISPNs are not new to the estate planning community, the country's increasing deficit will continue to bring them under Congress's microscope. Estate planners and grantors may wish Congress's attention would turn elsewhere, but it will not. EPs work to create substantial valuation discounts for their clients as a value added service, but potential legislation and the expiration of TRUIRJCA may end that shortly. Therefore, EPs should shift their attention now to the increased lifetime gift, estate, and GST tax exemption amounts available only in 2011 and 2012, and suggest ISPN substitutions, sales, or assignments to clients who can take advantage of lower-than-ever AFRs and depressed asset values to lower their gross taxable estates and effective estate tax liabilities.

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Asset values and interest rates are certain to increase, and it is likely that the increased lifetime gift, estate, and GST tax exemption amounts, and possibly valuation discounts as well, will disappear in the near future. Now is the time to transfer assets by way of IDGTs, FLPs, and ISPNs between the grantor and the IDGT, so that those same depressed value assets can appreciate once again free of gift, estate, and GST taxes for generations