7-2008

How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note

Bridget J. Crawford
Elisabeth Haub School of Law at Pace University

Recommended Citation
Bridget J. Crawford, Jonathan G. Blattmachr & Elisabeth O. Madden, How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note, 109 J. Tax'n 22 (2008), http://digitalcommons.pace.edu/lawfaculty/570/.

How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note

By Jonathan G. Blattmachr, Bridget J. Crawford, and Elisabeth O. Madden

Instead of paying off a high-interest-rate note to a family member with cash or with non-cash assets that might result in the recognition of gain, it appears possible for a borrower to issue a new note at the lower current AFR and substitute it for the old note, without adverse tax consequences.

JONATHAN G. BLATTMACHR and ELISABETH O. MADDEN are lawyers with Milbank, Tweed, Hadley & McCloy LLP, in New York City. BRIDGET J. CRAWFORD is a Professor of Law and Associate Dean for Research and Faculty Development, Pace University School of Law, White Plains, New York. Mr. Blattmachr has previously written for The Journal.

Intrafamilial arrangements labeled as loans have long invited special scrutiny from the IRS. In some cases, the Service has successfully established that the arrangement was not a loan but another type of transfer, such as a gift.[1] In the wake of several IRS victories in cases where somewhat "informal" financial arrangements between family members were held not to be loans,[2] many advisors to individual taxpayers counsel that when a child borrows money from a parent, for example, the loan should be documented, interest-bearing, secured, and repaid (at least in part), if the transaction is to be free of unexpected and in some cases adverse tax consequences.

In any event, even where the financial arrangement is respected as a loan, tax effects, such as generation of interest income taxable to the lender or the trigger of a gift tax on either the borrower or the lender, may arise. Some of these consequences will be discussed below along with a detailed look at some effects of substituting a new note at the "applicable federal rate" (AFR) that is lower than the interest rate payable on the old note.

STATUTORY CONTEXT

Under Section 7872, in the case of any below-market loan that is a gift loan or a demand loan, the "forgone interest" is treated as (1) transferred from the lender to the borrower, and (2) retransferred by the borrower to the lender as interest. Under Section 7872(f)(3), a "gift loan" means any below-market loan where the forgoing of interest is in the nature of a gift. A "below-market loan" is one that does not provide for interest at least equal to the AFR.

The AFR is established monthly by Treasury based on the rate "on outstanding marketable obligations of the United States" or, in other words, on the interest Treasury pays on obligations of the U.S. These interest rates are relatively low compared to commercially issued obligations, such as notes and bonds of which a corporation, a municipality, or an individual is the obligor.[3] Hence, if the interest provided on a gift loan is at least equal to the AFR, there is no forgone interest and the fundamental treatment prescribed by Section 7872 (that is, having interest treated as though it were transferred from the lender to the borrower and then retransferred by the borrower to the lender) does not apply.

PROMISSORY NOTES: PLANNING ASPECTS

Under Section 2501(a), a tax is imposed on the transfer of any property by gift by a U.S. citizen or resident.[4] For purposes of Section 2501(a), a "gift" is de-

fined in Section 2512(b) as a transfer for less than adequate and full consideration in money or money's worth. Reg. 25.2512-8 provides that, for purposes of Section 2501(a), a gift includes not only traditional donative transfers but also "below market" sales, exchanges, or other transfers of property where the value of the property transferred exceeds the value of consideration received.

The Supreme Court held in *Dickman*, 465 U.S. 330, 53 AFTR2d 84-1608 (1984), that interest-free loans between family members, even if repayable on demand, are gifts for federal gift tax purposes. *Dickman* did not decide how the amount of the gift would be determined, however. The complexity of that issue led to the enactment, soon after *Dickman* was decided, of Sections 1274(d) and 7872, which in essence direct that there will be a gift only to the extent the loan bears interest at a rate lower than the AFR.[5]

An exception to the rule that a gift occurs whenever the transferor receives back less in value than what the transferor transfers exists for bona fide transactions in which a transfer of property is made at arm's-length, without donative intent and in the ordinary course of business.[6] In such event the resulting transfer is deemed made for adequate and full consideration, and therefore is not a gift for federal gift tax purposes. In other words, if a seller of property has no intention of conferring a gratuitous benefit on the buyer, but the result of their arm's-length bargaining is that the buyer obtains the property for less than FMV[7] (as a result, for example, of the buyer's superior negotiating skills), the seller has not made a taxable gift to the buyer.[8] The seller may be an ineffectual negotiator and simply may have struck a poor bargain, but the transfer—even to the extent it is not in fact for full and adequate consideration in money or money's worth—is not subject to gift tax.

Similarly, one taxpayer may loan money to another, unrelated party in exchange for a note that bears interest below the prevailing market rate simply because the lender is uninformed about such matters. The lender likely would not be treated as making a gift by reason of the "ordinary course of business" exception to the federal gift tax rules.

By reason of the definition of gift under Section 2512(b), a transfer of assets for FMV (provided each side transfers money or something in money's worth) will not result in a gift for federal gift tax purposes. For example, if a seller transfers to a buyer a tract of undeveloped land for its FMV of $1 million, there is no gift.[9] The seller had land worth $1 million before the sale and has $1 million cash after the sale. And there is no gift because each party received full and adequate consideration in money or money's worth for what was transferred to the other. Nevertheless, the sale effectively transferred out of the seller's taxable estate any future appreciation in the value of the land while simultaneously giving the seller increased liquidity and the investment return that cash produces for the seller. For taxpayers who aim to minimize estate tax or increase liquidity (or both) without incurring gift tax liability, the cash sale of assets to another family member (such as a child or grandchild) is a practical and common estate planning technique where the parties anticipate the investment return on the asset sold will exceed what cash (or other assets) received in exchange will earn.

In the intrafamilial context, it is difficult, although not impossible, for transfers to qualify for this ordinary course of business exception.[10] If a parent, for example, sells an asset to a child for less than the asset's worth, the transfer will in most instances result in a gift.[11]

If made to a younger family member, the sale described above assumes that the younger-generation family member will have adequate liquid personal assets to purchase the property from the selling senior-generation family member. Even among wealthy families, however, that often is not the case. For reasons that range from youth, inexperience, lack of access to trust funds or other reasons, most younger-generation family members typically have less

NOTES

1 See, e.g., Estate of Van Anda, 12 TC 1158 (1949); Estate of Musgrove, 76 AFTR2d 95-5276 (Fed. Cl. Ct., 1995); Vinikoor, TCM 1998-152; Rev. Rul. 77-299, 1977-2 CB 343; Ltr. Rul. 7905090.

2 See, e.g., Estate of Maxwell, 98 TC 594 (1992), *aff'd* 3 F.3d 591, 72 AFTR2d 93-6733 (CA-2, 1993); see also Miller, TCM 1996-3; Santa Monica Pictures, LLC, TCM 2005-104; Estate of Rosen, TCM 2006-115. Each of these cases sets forth criteria to determine whether a particular arrangement will be treated as a loan for certain tax purposes.

3 Notes of which individuals are the obligors are often traded commercially where the notes are backed by a mortgage interest in the residences of the individuals.

4 See also Reg. 25.2501-1(a)(1). Certain transfers under Section 2503 are not subject to gift tax. Common transfers that are excluded from gift tax by that section are (1) "annual exclusion gifts" under Section 2503(b) (in 2008, $12,000 or less; subject in future years to adjustments for inflation), and (2) certain direct payments of educational or medical expenses under Section 2503(e). *Cf.* Section 2642(c) for comparable exclusions for generation-skipping transfer tax purposes.

5 See generally H. Rep't No. 98-432, 98th Cong., 2d Sess. II-1047 (1984); H. Rep't 98-861, 98th Cong., 2d Sess. 1012-1024 (1984) (Conference Report).

6 Reg. 25.2512-8.

7 Fair market value is defined as "the price at which property 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." See Regs. 20.2031-1(b) and 25.2512-1. See also Cartwright, 411 U.S. 546, 31 AFTR2d 73-1461 (1973).

8 Of course, the buyer could just as well be the "loser" if the seller has the superior negotiating skills and the buyer pays more for the property than it is worth.

9 Merely because a transfer is for full and adequate consideration in money or money's worth and is not a taxable gift does not necessarily mean that the net worth of the transferor has not been diminished. For example, a sale of a fractional interest in real property for the FMV of the fractional interest may diminish the seller's net worth: the FMV of the fractional interest sold is likely to be lower than a proportionate part of the FMV of the property as a whole, and after the sale the FMV of the retained fractional interest also is likely lower than a proportionate part of the FMV of the property as a whole. *Cf.*, e.g., LeFrak, TCM 1993-526.

10 *Cf.* Estate of Thompson, 382 F.3d 367, 94 AFTR2d 2004-5764 (CA-3, 2004); Beveridge, 10 TC 915 (1948).

11 Under Section 2701, a transferor is deemed to have made a gift, in some cases, involving transfers of interests in certain corporations and partnerships, based on a special "subtraction" method of valuation. See also Sections 2702, 2703, and 2704 for the special valuation rules that may "deem" a gift to have been made.

wealth than senior-generation family members. That may inhibit the transfer of "enhanced return assets" (like a unique private equity investment offered to only a few investors) to the younger family members.

Even where the financial arrangement is respected as a loan, tax effects, such as generation of interest income or the trigger of a gift tax, may arise.

Moreover, such a sale or exchange may cause recognition of gain for income tax purposes if the asset sold has an FMV greater than its income tax basis. An alternative to a sale for cash is an exchange of non-cash assets. But that type of exchange may cause gain recognition if either or both of the assets exchanged have an FMV greater than basis. A further option is to sell the non-cash asset for a note, where the worth of the note, in terms of money or money's worth, is equal to the FMV of the property purchased. But that too may result in gain.

Promissory notes in commercial practice. Promissory notes are a standard feature of many commercial transactions. Homeowners' loans, car loans, and student loans are common examples of arrangements by which one party (the borrower) explicitly agrees to repay another (the lender) pursuant to a formal document typically labeled as a "Promissory Note" or "Note." In fact, a good number of Americans have experience with promissory notes, although they may not realize it.[12]

For example, the standard credit card agreement contains what is essentially a promissory note. By signing the card agreement at the time of issuance, the consumer agrees to pay the card issuer for goods that the consumer buys from third parties. By signing a credit card slip at the gas station or verifying a personal identification number when charging sundries at the local drugstore, the consumer affirms the obligation to repay the credit card issuer.

Promissory notes in estate planning. It is, perhaps, less commonly known to the general public that promissory notes also are a common feature of many estate plans. Because AFR interest usually is lower—and often much lower—than returns available with respect to investment opportunities in the marketplace (or outside of it), an opportunity to shift wealth free of gift, estate, and generation-skipping transfer tax (collectively, "wealth transfer taxes") arises when one family member (such as a parent or grandparent) loans cash to another family member (such as a child or grandchild) at the AFR and the borrower invests it in a way in which it is anticipated that the return will exceed the AFR interest that the borrower is obligated to pay on the loan.

To the extent the borrower (e.g., the child) earns more on the investment than the AFR interest the borrower must pay to the lender (e.g., the parent), the borrower acquires wealth free of wealth transfer taxes. That may seem especially beneficial when the borrower would make the same type of investment that the lender would make: the inherent risk of the investment to the family as a whole does not change and, if the return is greater than the AFR, the excess return is shifted, free of wealth transfer tax, to another family member (such as a child or grandchild).[13]

Raising cash to loan. In some situations, a family member may not have cash to loan. Although cash might be obtained by borrowing from a third-party lender, such borrowing may not be viewed as beneficial to the family. Even if the borrower (e.g., a parent) re-loans to the other family member (e.g., a child), the interest rate charged by the third-party lender likely will be significantly higher than the AFR, essentially reflecting a risk-adjusted return.

Cash available for a family member to loan to another also might be raised through the sale of assets. But such a sale may be viewed as inappropriate if the family does not wish to sell those assets or because of recognition of gain on the sale. As indicated above, *Dickman* did not determine whether lending of non-cash assets for less than full FMV rent results in an imputed transfer for gift and income tax purposes, but there seems to be at least some risk the IRS would claim there is a transfer in such a case.[14]

Similarly, Section 7872 appears to apply only to a loan of cash (that is, an extension of credit), not to a loan of non-cash property. If an owner is treated as making a transfer by a loan of non-cash property and if, as

NOTES

12 According to the Federal Reserve's Consumer Credit statistics, as of the end of the end of 2007 the amount of outstanding consumer credit exceeded $2.5 trillion dollars. Federal Reserve Statistical Release, available at www.federalreserve.gov/Releases/G19/Current/ (last visited 5/30/08).

13 Obviously, the amount of wealth transfer tax avoided is greater if the loan is to a grandchild or more remote descendant as opposed to a child, because a transfer to a child may be subject to only one of the wealth transfer taxes (estate or gift tax) and the transfer to a grandchild or more remote descendant may be subject to two wealth transfer taxes (estate or gift tax and generation-skipping transfer tax).

14 Perhaps the tax effects, if any, of the rent-free use of the property might turn on the type of asset and the use to which it is put. For example, a parent holds tangible personal property (e.g., aircraft) that is rented to the public at a profit. If the parent loans the aircraft to one of her children for no rent, the child could lease the planes to the public and capture the profit. It may be that the IRS would take the position that the rent-free use of the aircraft by the child has some tax consequences. By contrast, the use by a child of a non-income-producing asset (such as a summer home the family uses and does not rent) might yield a different result. See Dickman, 465 U.S. 330, 53 AFTR2d 84-1608 (1984): "Our laws require parents to provide their minor offspring with the necessities and conveniences of life; questions under the tax law often arise, however, when parents provide more than the necessities, and in quantities significant enough to attract the attention of the taxing authorities. Generally, the legal obligation of support terminates when the offspring reach majority. Nonetheless, it is not uncommon for parents to provide their adult children with such things as the use of cars or vacation cottages, simply on the basis of the family relationship. We assume that the focus of the Internal Revenue Service is not on such traditional familial matters. When the Government levies a gift tax on routine neighborly or familial gifts, there will be time enough to deal with such a case."

it seems to be, Section 7872 does not apply to loans of non-cash assets, the AFR safe-harbor of that section is unavailable.

SALE OF ASSET FOR A PROMISSORY NOTE

An alternative to an intrafamilial cash loan is an asset sale at its FMV for a promissory note bearing at least AFR interest.[15] Although such a sale should avoid imputed "interest" or "rent," the sale could result in income taxation of gain and the AFR interest due under the note. Nevertheless, income tax on gain and on any interest accrued or paid on the promissory note used to pay for the asset may be avoided if the purchaser-borrower is a grantor trust with respect to the seller-lender.[16] That transaction is commonly known as an installment sale to a grantor trust, an estate planning technique that became popular in the late 1990s.[17]

In this technique, a senior-generation family member will sell assets to a trust, which is designed and administered to attempt to avoid its inclusion in the gross estate of the grantor but nonetheless be ignored for income tax purposes with respect to the seller. Typically, the purchasing grantor trust is for the benefit of one or more members of the generation(s) younger than the grantor-seller, in return for a promissory note issued by the trust bearing AFR interest. To the extent that the assets in the trust appreciate or generate income at a rate greater than the interest owed to the seller, the trust for the younger-generation family members will be able to meet their interest obligations to the seller and "pocket" the profit free of income and wealth transfer taxes.[18]

Notes With Rates at or Above AFR

As explained above, interest-free and below-market loans ordinarily are recharacterized under Section 7872 as arm's-length transactions in which the lender is deemed to have made the loan to the borrower at an adequate interest rate (that is, at the AFR) and the borrower is deemed to have paid the interest to the lender in a manner such that "forgone" interest is imputed for income or gift tax purposes. For purposes of Section 7872, as discussed above, a "below-market loan" is one payable at a rate less than the AFR under Section 1274(d) (for a demand loan[19]) or a loan in which the amount loaned exceeds the present value of all payments due under the loan (for a term loan[20]). As discussed above, a below-market loan has both gift tax and income tax implications.[21]

For gift tax purposes, if a below-market loan is a demand loan, the lender will be deemed to have made a gift to the borrower on the last day of each year the loan is outstanding.[22] For a below-market term loan, the lender will be deemed to have made a cash gift to the borrower on the date the loan is made. As a general rule, the deemed gift is the amount by which the AFR interest exceeds the interest, if any, provided under the note (that is, the forgone interest). If the note bears appropriate AFR interest for its term, the note is worth its face amount (that is, equal to the amount loaned).

For income tax purposes, if an interest-free or below-market loan is a gift loan,[23] the deemed interest will be includable in the lender's income for income tax purposes.

The Proposed Regulations[24] would make clear that Section 7872 will not apply to loans having sufficient stated interest.[25] A loan has "sufficient stated interest" if it provides for interest on the outstanding loan balance at a rate no lower than the AFR based on the compounding period appropriate for the loan.[26]

By definition, loans at or above the AFR are not interest-free loans

NOTES

15 The IRS has limited the circumstances in which promissory notes may be used as cash substitutes, however. See, e.g., Reg. 25.2702-3(b)(1)(i) (issuance of a promissory note will not satisfy an obligation to pay a "qualified annuity amount" under Section 2702, applicable to certain "split-interest" trusts, including most grantor retained annuity trusts). See also Hodgman, "Take Note: IRS Disallows Use of Notes for GRATs or GRUTs," 26 Estate Planning 352 (October 1999).

16 In a grantor trust, the income, deductions, and credits against tax of the trust are attributed to the grantor essentially as though the trust did not exist and the assets of the trust were owned by the grantor. See Section 671. The Service has ruled that the existence of the trust is ignored for federal income tax purposes; see Rev. Rul. 85-13, 1985-1 CB 184. That means, among other things, that any gain inherent in the asset sold to the grantor trust is not recognized and interest paid by the trust to the grantor is not subject to income tax.

17 See, e.g., Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 Estate Planning 3 (January 1996).

18 A grantor trust also may provide other benefits. Because the income earned by the trust is imputed to the grantor and because, under Rev. Rul. 2004-64, 2004-2 CB 7, the grantor is not treated as making a gift by paying the income tax on that income, even if the grantor does not receive that income, the trust may grow on an income-tax-free compounded basis and without the payment of gift tax by reason thereof.

19 A demand loan is any loan that is payable in full at any time on the demand of the lender; see Section 7872(f)(5).

20 A term loan is any loan that is not a demand loan; see Section 7872(f)(6). The valuation of the term loan is based on a present value calculation using AFR to determine the note's current value under Section 7872. If the term note bears at least AFR, its value will not be determined to be lower for purposes of Section 7872 than the amount borrowed and, as a result, the lender will not be deemed to have made a gift to the borrower.

21 See, e.g., Frazee, 98 TC 554 (1992) (finding that taxpayers sold tract of land worth $1 million to their children for $380,000, payable solely by 20-year mortgage note in that amount bearing interest at 7%, and holding that Section 7872 provides the correct interest rate to discount the promissory note for gift tax purposes).

22 Section 7872(a)(2).

23 A gift loan is any below-market loan where the forgoing of the interest is in the "nature of a gift." Generally, any below-market interest loan not made in the ordinary course of business is considered made for less than full and adequate consideration and is treated as a gift loan. The Section 7872(c)(2) exception for any loan directly between individuals not in excess of $10,000 does not apply "for any gift loan directly attributable to the purchase or carrying of income-producing assets." Also, the exclusion under Section 7872(d)—for income tax purposes, of imputed interest on a loan that does not exceed the borrower's net investment income for the year with respect to a gift loan directly between individuals not in excess of $100,000—does not apply if the loan has the avoidance of income tax as one of its principal purposes.

24 As a general matter, Proposed Regulations do not have the force of law. See, e.g., Estate of Howard, 91 TC 329 (1988), *rev'd* 910 F.2d 633, 66 AFTR2d 90-5994(CA-9, 1990). Final Regulations under Section 7872 have been issued with respect to certain "split-dollar" insurance arrangements; see Reg. 1.7872-15.

25 Prop. Reg. 1.7872-3(c)(1).

26 *Id.*

or below-market loans; therefore, there is no taxable gift associated with a loan at an AFR based on the appropriate compounding period.[27] Hence, where a borrower's original note has adequate stated interest, if the borrower repays the lender and takes out a second loan with adequate stated interest, there should be no taxable gift at any point in this series of transactions.[28]

Accordingly, in the context of a promissory note issued by a younger-generation family member/purchaser to the senior-generation family member/seller, as described above, if that note bears interest at least at the AFR, there should be no gift tax consequences or additional adverse income tax consequence to either party in making the loan or in repaying it. Moreover, as mentioned above, there would be no income tax consequence if the loan were between a grantor and a trust that was a grantor trust with respect to the grantor.

Declining Applicable Federal Rates

For the period from January 1989 through June 2008, the AFR with respect to midterm[29] notes with semi-annually compounded interest ranged from a high of 9.47% in May 1989 to a low of 2.72% in May 2008. The rate for June 2008 was 3.17%.[30] The economic impact of the rate of the AFR is illustrated below.

EXAMPLE: Lender holds a $1 million, eight-year note with accrued interest compounded semi-annually that was issued on 5/1/89 providing for the interest to accrue at the then mid-term AFR of 9.47%. The note holder (lender) would receive approximately $2,060,000 in interest at the end of eight years when the note matures. In contrast, the same eight-year note issued on 5/1/08, when the mid-term AFR was 2.72%, would result in interest paid at the end of the eight-year term of only about $1,240,000.

EFFECTS OF NOTE SUBSTITUTION

The declining AFR may present an opportunity for family borrowers and lenders who currently have promissory notes bearing interest higher than the current AFR.

One option may be for the borrower simply to pay off the old (higher AFR) loan (plus accrued interest) and then borrow again at the current (lower) AFR. If the borrower does not have the cash to do that, the borrower likely could pay off the note with non-cash assets, but would recognize gain if the FMV of the assets exceeds the borrower's income tax basis in the assets (unless the borrower and lender are treated as the same taxpayer,[31] or another provision of the tax law would prevent the recognition of gain[32]).

A gift includes not only donative transfers but also 'below market' transfers where the value of the property transferred exceeds the value of consideration received.

It seems that the borrower also may issue a "new" note at the current (low) AFR and substitute this for the "old" note at the original (higher) AFR without adverse tax effect, at least where the notes permit prepayment at any time.

It is possible that the IRS would contend, perhaps under the "step transaction" doctrine,[33] that all that happened in the end was that the lender simply accepted a new lower AFR note for the older higher AFR note.[34] But that, in turn, raises the question of the tax effects, if any, of having the lender and borrower merely cancel the higher interest AFR note and substituting a lower interest AFR note in its place. Although there is no case, ruling, or Code section that explicitly provides that promissory notes may be restated without gift tax effects, economic analysis of the transaction and Regulations strongly support the conclusion that it is possible to do so without a taxable gift being deemed to occur.

Many of the promissory notes used in the intrafamilial context are term (rather than demand) notes that provide that the borrower may, at the borrower's option, prepay all

NOTES

27 In general, whether AFR interest is charged on the loan or is imputed because no interest or interest below the AFR is charged, the income tax effect will be the same: the borrower is treated as paying interest (which for income tax purposes may or may not be deductible in whole or in part under Section 163) and the lender is treated as receiving such interest (which is included in the lender's gross income under Section 61). In each of these situations, the interest paid or received is the amount of the AFR interest.

28 Section 7872, however, would not seem to preclude the Service from contending that a gift is made by a borrower if the borrower agrees to pay more than a market rate of interest. For example, if a parent borrowed from her child and agreed to pay annual interest of 50%, the IRS would not seem to be prevented by Section 7872 from contending that the parent made a taxable gift with respect to some portion of the interest.

29 Under Section 1274(d), the AFR varies depending on the length of the debt instrument. For a debt instrument with a term of not over three years, the short-term rate applies. For a debt instrument with a term over three years but not more than nine years, the mid-term rate applies. For a debt instrument with a term over nine years, the long-term rate applies.

30 The short-term, mid-term, and long-term rates are determined based on the preceding two months' average market yield on marketable Treasury bonds having a corresponding maturity. For further discussion, see Whitty, "Effects of Low Interest Rates on Investment-Driven Estate Planning Techniques," 30 Estate Planning 587 (December 2003). For AFRs, see, e.g., Rev. Rul. 2008-28, 2008-22 IRB 1029. See also Frazee, *supra* note 21 ("In effect, section 7872 requires that all loans among related parties bear an interest rate based on the then-current applicable Federal rate").

31 For example, transactions between a grantor and a trust that is treated as a grantor trust for income tax purposes are ignored for income tax purposes. See Rev. Rul. 85-13, *supra* note 16, but *cf.* Rothstein, 735 F.2d 704, 54 AFTR2d 84-5072 (CA-2, 1984).

32 See, e.g., Section 1041 (no gain recognized on the transfer of assets between spouses, as a general rule).

33 See Clark, 489 U.S. 726, 63 AFTR2d 89-860 (1989) ("Under [the 'step transaction'] doctrine, interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. By thus 'linking together all interdependent steps with legal or business significance, rather than taking them in isolation,' federal tax liability may be based 'on a realistic view of the entire transaction.' 1 Bittker, Federal Taxation of Income, Estates and Gifts ¶4.3.5, p. 4-52 ([Thomson Reuters/WG&L,] 1981)"). See also Brown, 329 F.3d 664, 91 AFTR2d 2003-2085 (CA-9, 2003).

34 The "mystical" tax doctrines, including the step transaction doctrine, often have been applied in the wealth transfer tax arena. See Soled, "Use of Judicial Doctrines in Resolving Transfer Tax Controversies," 42 B.C. L. Rev. 587 (2000-2001).

or any portion of the principal of the promissory note at any time without premium or penalty of any kind.[35] Whether or not this right to prepay is restricted, if the borrower has the funds available, it seems that the borrower, without negative gift or income tax consequences, may repay the lender in advance of the maturity date, thereby decreasing the amount of total interest that would accrue on the borrower's debt (and, as a result, the total payment the lender expected to receive under the note in the absence of repayment).

Current Law Suggests Substitution Is Gift Tax Free

There is little question that an intrafamilial exchange of promissory notes having different FMVs usually will be treated as a gift, just like the intrafamilial exchange of virtually any property having different FMVs is a gift (unless falling under the "ordinary course of business" exception).

EXAMPLE: A mother owns a note issued by a publicly traded corporation, which is due 3/31/10 and bears 10% interest, payable annually at the end of March each year. Her daughter owns an identical note from the same corporation except it bears 6% interest. The mother and daughter trade their notes with each other, so the parent winds up owning the 6% note and the child the 10% note. Assuming that the ordinary course of business (or "poor bargain") exception in Reg. 25.2512-8 does not apply, whether a transferor has made a gift depends on whether the FMV of the note transferred is greater than the FMV of the note received.

Determining the gift tax value of marketable notes. Reg. 25.2512-2(a) provides 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. So the simple task here, to decide the likely gift tax effects of the exchange in our example, is to determine if one note was trading in the marketplace for more than the other on the date the mother and daughter swapped the obligations.

All other factors being equal, the value (or trading price on the exchange) of the note bearing 10% interest would be greater than the trading price (value) of the note bearing 6% interest. In that event, the mother would likely be treated as making a gift to the daughter to the extent the FMV of the 10% note exceeded the FMV of the 6% note. But there could be at least two circumstances under which the notes would be worth the same, or approximately the same:

1. The company-obligor may be so financially distressed that the prospects of interest being paid on either note is nil. In that case, the notes might both be so severely discounted from face (the amount to be paid at maturity) that they are trading on the exchange at the same price.

2. Where both notes are subject to a recall or redemption, the higher interest rate note may not be worth more than the lower interest note. The corporation (or other obligor) may have the right to prepay the notes at any time at face without penalty (or with the same premium) at any time. If market conditions are such that paying off the notes is virtually compelled (because, for example, the corporation could issue new notes of the same maturity at 3% rather than current rates of 6% and 10% that the outstanding notes carry), the two notes may be trading at the same price—probably at face.

As has been observed in the marketplace, "[i]n addition to reinvestment-rate risk, investors must also understand that market prices for callable bonds behave differently than normal bonds. *Typically, as rates decrease bond prices increase, but this is not the case for callable bonds.* This phenomenon is called 'price compression' and is an integral aspect of how callable bonds behave."[36]

Hence, it may well be that the two corporate bonds will have the same or close to the same market value even though their interest rates are far apart. Economically an exchange of such marketable notes should not trigger any gift tax liability.

Determining the gift tax value of nonmarketable notes. In the case of nonmarketable bonds and notes (e.g., family promissory notes), different valuation principles suggest that the FMV, for gift tax purposes, of the "old" note bearing a higher AFR interest will be the same as the "new" note, bearing a lower AFR interest.

A transfer made at arm's-length, without donative intent and in the ordinary course of business, is deemed made for adequate and full consideration.

First, as suggested above, a note that may be prepaid without penalty at any time likely is worth little more than face value. That seems even more certain with respect to a nonmarketable note because a private issuer (unlike, e.g., a public company) likely can pay off the note without approval of any governing body, anticipated adverse public reaction to its actions, or other factors that may apply to a public company. Although Section 7872(h) may authorize gift tax Regulations concerning the valuation of intrafamilial notes (carrying interest at the AFR after they are issued), no such Regulations have been promulgated (although, as discussed below, Regulations on the value of such notes for estate tax purposes have been proposed). Hence, it appears that family notes

NOTES

35 See 60 Am. Jur. 2d, *Payment*, § 8 (2008): "There is some confusion as to whether at common law there was no right to compel a creditor to accept the prepayment of a debt where the contract was silent as to prepayment. However, when a debt is payable on or before a certain date, the obligor has a right to discharge the debt at any time before the time stated."

36 See Petroff, "Callable Bonds: Leading a Double Life," Investopedia, available at www.investopedia.com/articles/bonds/07/callable_bonds.asp. (emphasis added).

should be valued in accordance with other valuation principles.

And it seems that such notes will *not* be valued in accordance with Reg. 25.2512-2(a), which refers to the exchange on which a bond is traded, because family notes are not traded on an exchange. Instead, family notes likely will be valued for gift tax purposes in accordance with Reg. 25.2512-4, which states: "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."

In the intrafamilial context, it is difficult, although not impossible, for transfers to qualify for the ordinary course of business exception.

Proposed Regulations under Section 2512, issued in conjunction with Proposed Regulations issued under Section 7872, strongly support the notion that Reg. 25.2512-4 must be used to value, after it has been issued, a note where the loan is in the nature of a gift (e.g., a loan from one family member to another or a trust for his or her benefit). The last sentence of Prop. Reg. 25.2512-4 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." By making reference to Section 7872, Treasury seems to imply that the valuation of non-marketable (that is, not publicly traded) notes is determined under Section 2512 except to the extent the final Regulations under Section 7872 provide otherwise.

Even if Prop. Reg. 25.7872-1 were a final Regulation, it seems to provide a rule only for determining the value of a term loan note *at the time the loan is made*, not when the note is retransferred (or paid off). In any event, according to its heading the Proposed Regulation applies only to "Certain Below-Market Loans." A loan at AFR interest is not a below-market loan, and therefore the Proposed Regulation would not apply to a note bearing at least AFR interest.[37]

Notes with different AFRs are worth the same. Reg. 25.2512-4, which seems to determine the FMV of a family note, presumes the note has an FMV equal to its face amount. And, perhaps more important, the Regulation seems to allow variation of value only to establish the note is worth less than face amount. There is no indication that the IRS (or a taxpayer) is permitted to establish it has a value *greater* than the face amount. Thus, even if the interest on the family note is greater than current AFR—and, it seems, even if the AFR on the note is greater than what the market rate on such a note would be (e.g., the note bears 8% interest and the borrower-obligor could borrow from a commercial lender at less than that rate)—the note cannot be treated as having a gift tax value greater than its face amount.

Proposed estate tax Regulations support that conclusion. Prop. Reg. 20.7872-1 provides in 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." (Emphasis added).

The Preamble to the Proposed Regulation explains: "In addition, proposed § 20.7872-1 implements section 7872(g)(2) [now (h)(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."[38] The note, under the estate tax Proposed Regulations, could never be valued at greater than face amount (plus accrued interest).

When the borrower would make the same type of investment that the lender would make, the inherent risk of the investment to the family as a whole does not change.

As indicated above, and perhaps somewhat surprisingly, the gift tax Proposed Regulations do not contain a rule on the valuation of notes for gift tax purposes after they have been issued. All the Preamble states with respect to gift tax is that "Proposed § 25.7872-1 implements 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."[39]

Accordingly, it seems the valuation of a family note, after it is issued, is determined pursuant to Reg. 25.2512-4, which also appears to limit its value to no more than its face amount (plus accrued interest). And there is no different gift tax valuation rule based on whether or not the note may be prepaid without penalty.[40] Although a note that cannot be repaid without a penalty may have a higher value than one that can be, Reg. 25.2512-4 still limits the highest value to its face amount.

It seems nearly certain, therefore, that a family note issued at the AFR which is higher than the current AFR

NOTES

37 See also Ltr. Rul. 9240003.

38 50. Fed. Reg. 33553 (8/20/85).

39 *Id.*

40 *Cf.* Estate of Graegin, TCM 1988-477.

has an FMV for gift tax purposes *not greater* than its face amount. It seems presumed to have a gift tax value exactly equal to its face amount. Also, under Section 7872, a note that bears the current AFR at the time it is issued has a value for gift tax purposes equal to its face amount.

As a result, there should be no gift if a note made by a family member with a lower AFR is substituted for a pre-existing one that bears a higher interest rate: the "old" note has a gift tax value presumed under Reg. 25.2512-4 to be equal to its face amount and the "new" note substituted for it has a gift tax value, under Section 7872, at the time it is substituted for the old note, also equal to its face amount. Because the notes thus have equal values at the time of substitution, it is an exchange of property with equal values, and therefore there is no gift.[41]

The Proposed Regulations would make clear that Section 7872 will not apply to loans having sufficient stated interest.

It is unlikely, but not impossible, that the IRS could argue that the old note (bearing higher AFR interest) is worth less than its face amount, so that when the borrower issues a new note (bearing current, lower AFR interest) which is worth its face amount, the borrower (e.g., the child) makes a gift to the lender (e.g., the parent). But such an argument would be contrary to the estate tax Proposed Regulations that limit value to no more than face, even if the AFR on the valuation date is lower than the rate carried on the family note. It also would mean that the borrower makes a gift by paying off the note prior to maturity.

It seems highly unlikely that a taxpayer could be treated as making a gift by paying off what he or she owes. And, perhaps more important, it would mean that a taxpayer could loan money to one child by taking back an AFR note and then retransfer the note to another child, claiming a gift tax value at less than its face amount. That would open such an enormous opportunity for gift tax avoidance that it is inconceivable the Service would make the argument that an older family note bearing interest higher than current AFR, even if the note cannot be prepaid, is worth less than face amount.

Income Tax Effects of Note Substitution

Under Section 1001, a taxpayer realizes gain or loss on the sale or other disposition of property. The gain from the sale or other disposition is the excess of the amount realized over the adjusted basis; and the loss is the excess of the adjusted basis provided in the section for determining loss over the amount realized. In general, 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. All realized gain is recognized unless a nonrecognition provision applies.

In the example above where the mother and daughter exchange publicly traded notes, one or both of them may realize a gain or loss if income tax basis is greater than or less than the FMV of the bond received in exchange.[42] Reg. 1.1001-1(a) provides, in part, that "the gain or loss realized from ... the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained." In fact, a taxpayer may realize gain or loss when a debt obligation the taxpayer holds is not exchanged for other property but merely is significantly modified, including, in general, a change (other than a de minimis one[43]) in the interest rates.[44]

Practice Notes

The decline in the applicable Federal rate that is commonly used in intrafamily promissory notes in order to avoid the application of Section 7872 means that there are many loans outstanding that are carrying interest rates well above the current AFR levels. Under the existing Regulations, substituting a new note with the lower current AFR should not have any negative tax impact for any of the parties.

Accordingly, an exchange or substitution of one family note bearing lower interest for another bearing higher interest or a reduction in the interest rate (down to current AFR) could be a realization event under Section 1001. As indicated above, however, if the borrower and the lender are two grantor trusts with respect to the same grantor or if one is a grantor trust of which the other party is the grantor, no gain or loss will be recognized.[45]

What if the indebtedness is between two different taxpayers, such as a parent and child or a parent and a trust for the parents' descendants that is not a grantor trust?[46] When the ex-

NOTES

[41] The gift tax value of the "old" note may be increased for any accrued and unpaid interest at the time of substitution of notes, which may mean, to avoid making any taxable gift, that such interest be paid or the principal amount of the new note be increased by such interest.

[42] In certain circumstances, a realized loss may not be recognized (that is, may not be used for income tax purposes). See, e.g., Section 267(a).

[43] See, e.g., Reg. 1.1001-3(e)(2)(ii).

[44] Reg. 1.1001-3. See Rev. Rul. 89-122, 1989-2 CB 200, Rev. Rul. 87-19, 1987-1 CB 249, and Ltr. Rul. 9127003 for illustrations. See also Cottage Savings Ass'n, 499 U.S. 554, 67 AFTR2d 91-808 (1991); Kirby Lumber Co., 284 U.S. 1, 10 AFTR 458 (1931).

[45] Rev. Rul. 85-13, *supra* note 16. Also, if the borrower and lender are husband and wife, a grantor trust of one spouse and either the other spouse or a grantor trust with respect to such other spouse, no gain or loss should be recognized. See Section 1041. It seems, under Rev. Rul. 85-13, that if the trust is a grantor trust with respect to either spouse, the Section 1041 exception should not apply.

[46] It may be that the trust could be made a grantor trust with respect to the other party, which should avoid the gain issue if the note is materially modified or exchanged for another note of the same maker. The consequences of terminating nongrantor trust status would have to be considered. *Cf.* Rev. Rul. 77-402, 1977-2 CB 222.

change or deemed exchange occurs, the lender and/or borrower may recognize income or loss. It seems that the borrower, who will be substituting (or treated as substituting even if it is merely a substantial modification of the pre-existing note) a lower-interest-rate note for the one outstanding, could have cancellation of indebtedness (COD) income if the note substituted has a lower value (because it bears lower interest) than the one for which it is substituted.

Nevertheless, COD income will result from the exchange or deemed exchange only if the "issue price" of the new debt instrument is less than the "adjusted issue price" of the original note.[47] Section 108(e)(10) provides, in part, "[f]or purposes of determining income of a debtor from discharge of indebtedness, if a debtor issues a debt instrument in satisfaction of indebtedness, such debtor shall be treated as having satisfied the indebtedness with an amount of money equal to the issue price of such debt instrument."

Reg. 1.61-12(c)(2)(ii) provides, in part, that "[a]n issuer realizes income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price (within the meaning of [Reg.] § 1.1275-1(b))." In order to determine the "issue price" of the new debt instrument, Section 108(e)(10) also provides that the issue price of any debt instrument is determined under Sections 1273 and 1274. For non-publicly traded debt instruments,[48] Section 1274 provides that where the "new" debt instrument bears at least AFR interest, the "issue price" is the stated principal amount (that is, face amount).[49]

Reg. 1.1275-1(b) provides that the "adjusted issue price" is the original issue price (increased by the amount of original issue discount (OID) already included in the gross income of the holder and decreased by the amount of any payment already made on the debt instrument other than a payment of qualified stated interest). Hence, it seems relatively certain that, unless the original note is an OID note or some payment other than interest has been made under it, there should be no COD income by the modification of a note to provide for it to carry current AFR interest that is lower than the interest under the pre-existing note, or the substitution of a note bearing current AFR interest that is lower than the interest on the note for which it is being substituted.[50]

Presumably, the note held by the lender has a basis equal to face amount—either the amount of money lent or the FMV of the assets sold for the note in a taxable exchange, unless the seller was permitted to and is reporting the gain on the installment basis under Section 453. When the exchange occurs, it may well be that the new (lower interest) note, in fact, has a value lower than old (higher interest) note, which again likely has a basis equal to face amount.[51]

It does not appear that Section 7872 provides that, for purposes of gain or loss, a loan in the nature of a gift that bears AFR interest has any particular prescribed value at the time it is retransferred. It seems therefore that the lender by accepting a note with lower interest may realize a loss. But it is doubtful the loss will be allowed for income tax purposes. First, Section 267(a) disallows any deduction in respect of any loss from the sale or exchange of property, directly or indirectly, between certain persons (and certain entities, such as trusts, in which they have interests) including the taxpayer's lineal descendants and brothers and sisters. Second, Section 183 disallows deductions for activities not engaged in for profit. It seems that a voluntary substitution of a lower interest note one family member holds and that was issued by another family member may well be such an activity within the meaning of that section.[52]

More to the point, however, is Section 165, which disallows losses to an individual except for (1) losses incurred in a trade or business, (2) losses incurred in any transaction entered into for profit although not connected with a trade or business, and (3) certain losses of property

NOTES

47 To the extent, if any, that the forgiveness of a family loan constitutes a gift from the lender to the borrower, there is no gross income. See Section 102.

48 It seems nearly certain that a family note will not be a publicly traded debt instrument.

49 Although Section 1273 also has rules for determining "issue price," its rules do not apply where Section 1274 applies; see Section 1273(b)(4)(B). Nevertheless, under Reg. 1.1274-1(a), "section 1274 [only] appl[ies] to any debt instrument issued in consideration for the sale or exchange of property." And, it seems, where the note is issued with AFR interest, Section 1274 applies because one note is being exchanged for another, unless an exception (e.g., sale of a farm or home) applies. For example, in certain instances, Section 1274 will not apply if the note bears interest at the AFR and the interest is "qualified stated interest"; see Reg. 1.1274-1(b)(1). Pursuant to Reg. 1.1273-1(c)(1)(i), "qualified stated interest" is, in general, "stated interest that is unconditionally payable in cash or in property (other than debt instruments of the issuer), or that will be constructively received under section 451, at least annually at a single fixed rate (within the meaning of paragraph (c)(1)(iii) of this section)." Under Section 1273(b)(4), the issue price is "the stated redemption price at maturity." Reg. 1.1273-1(b) provides that "[a] debt instrument's stated redemption price at maturity is the sum of all payments provided by the debt instrument other than qualified stated interest payments." It appears, then, that in most instances the issue price of family indebtedness will be the same under Section 1273 as it would under Section 1274 —that is, face amount. There are several other special rules and limitations applicable to Sections 1273 and 1274.

50 As already noted, account must be made for accrued but unpaid interest at the time of the substitution of the old note for the new note.

51 Section 453B provides that, as a general rule, if an installment obligation is satisfied at other than its face value or is distributed, transmitted, sold, or otherwise disposed of, gain or loss will result to the extent of the difference between the basis of the obligation and either (1) the amount realized, in the case of satisfaction at other than face value or a sale or exchange, or (2) the FMV of the obligation at the time of distribution, transmission, or disposition, in the case of the distribution, transmission, or disposition otherwise than by sale or exchange; any such gain or loss so resulting is considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received.

52 *Cf.* Reg. 1.183-1(e), which provides: "For purposes of section 183 and the regulations thereunder, gross income derived from an activity not engaged in for profit includes the total of all gains from the sale, exchange, or other disposition of property, and all other gross receipts derived from such activity. Such gross income shall include, for instance, capital gains, and rents received for the use of property which is held in connection with the activity. The taxpayer may determine gross income from any activity by subtracting the cost of goods sold from the gross receipts so long as he consistently does so and follows generally accepted methods of accounting in determining such gross income."

family members, any loss experienced by the lender by permitting the substitution of a lower interest rate will not be allowed for income tax purposes.

CONCLUSION

The substitution of one family note for another should not be treated as a gift by either the borrower or the lender if the substituted (new) note

same gift tax value. Accordingly, there can be no gift.

If the indebtedness is between entities that are treated as the same taxpayer for income tax purposes (such as a grantor trust with respect to the other party), there should be no income tax consequence in exchanging one note for another. Even if the lender and borrower are different taxpayers, and even if the substitution of a lower interest note for a

Assuming the lender's basis in the note is greater than the value of the substituted note, it seems the seller-lender might experience a loss. It is likely, however, that any such loss would be disallowed for income tax purposes because it did not arise in a transaction entered into for profit. ■