Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Associate Area Counsel, CC:SB:7:SF:3
(Small Business/Self-Employed)

from: Senior Counsel, Branch 2
(Passthroughs & Special Industries)

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subject: Request for Chief Counsel Advice

This Chief Counsel Advice may not be used or cited as precedent.

LEGEND

X	=
Partnership	=
A	=
B	=
C	=
D	=
A's Trust	=
B's Trust	=
C's Trust	=
D's Trust	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
a	=
b	=
c	

Trustee =
Year 1 =
Year 2 =

ISSUES

1. Whether the conversion of a nongrantor trust to a grantor trust is a transfer for income tax purposes of the property held by the nongrantor trusts to the owners of the grantor trusts requiring recognition of gain to the owners.

2. Whether the grantors of the trusts are considered to have indirectly borrowed the trust property by selling partnership interests to the trusts in exchange for unsecured annuities, thus becoming the owners of the trusts under § 675(3) of the Code and causing the sale to be disregarded for federal income tax purposes.

CONCLUSIONS

1. The conversion of a nongrantor trust to a grantor trust is not a transfer for income tax purposes of the property held by the nongrantor trusts to the owner of the grantor trust that requires recognition of gain to the owner.

2. The grantors of the trusts are not considered to have indirectly borrowed the trust property by selling partnership interests to the trusts in exchange for unsecured annuities, thus becoming the owners of the trusts under § 675(3) and causing the sale to be disregarded for federal income tax purposes.

FACTS

A and A's three adult children, B, C, and D (the Family) owned stock in X, a subchapter S corporation. On Date 1, X filed a Form S-1 with the SEC to register securities in anticipation of an Initial Public Offering (IPO). The S-1 stated that the Family intended to sell 100% of their shares, except for A, who intended to sell 50% of A's shares. As of Date 1, shares of X held by the Family were significantly appreciated.

On Date 2, the Family and A's spouse, formed Partnership, a limited liability company treated as a partnership for federal income tax purposes. Upon forming Partnership on Date 2, the Family and A's spouse contributed nominal amounts of cash. On Date 3, A, B, C, and D each contributed their appreciated shares of X to Partnership. Under § 722, A, B, C, and D each acquired a basis in their Partnership interest equal to their adjusted basis in their respective shares of X and the nominal amount of cash contributed. Likewise, under § 723 Partnership succeeded to the Family's low basis in the contributed shares of X.

On Date 4, A, B, C and D each formed an irrevocable long term trust (Family Trusts) and funded each trust with $100,000. These trusts were not grantor trusts ("nongrantor

trusts"). The grantor of each trust was the person whose initials designated the trust. For example, the grantor of the A Long Term Trust (the A Trust) was A.

All of the Family Trusts contained the same basic provisions. The beneficiaries were the grantor's then living issue. The trustees were: (1) A's Spouse (2) an independent trustee, and (3) an independent corporate trustee. A majority of the trustees had the discretionary power to distribute net income to any of the beneficiaries. Unless terminated by the distribution of the entire trust, the trust terminated upon the grantor's death. Upon termination, the trustees were to distribute the trust fund to the grantor's living issue, or if no such issue, the living issue of the grantor's mother (all in trust).

On or about Date 3, (which is prior to 2006) the Family sold their entire Partnership interests to their respective trusts in exchange for unsecured private annuities. The annuity agreements vary with respect to the amount of the fixed annual annuity payment due to the transferor, based on the age of the transferor.

At the time of the Family's sale of their Partnership interests to the Family Trusts, Partnership made an election under § 754 to make adjustments to the basis of partnership property. Because this election was in place, immediately after the transfer of the partnership interests to the Trusts, Partnership stepped up its inside basis of the stock of X to its fair market value of $a (which corresponds to the Family Trusts' purchase price and outside basis in their Partnership interests).

On Date 5, Partnership sold all of its shares of X pursuant to the IPO for $b, an amount roughly equal to Partnership's inside basis in its X shares. On its Year 1 federal partnership income tax return, Partnership reported long-term capital gain of $c from the IPO. On the Schedule K-1s attached to the return, Partnership also reported distributions to each trust approximately equal to the amount of that trust's annuity payments to the Family. A, B, C, and D respectively reported income that they received from the annuities in Year 1 on their Year 1 individual income tax returns. They did not report their entire amount realized from the sale of Partnership interests to their respective trusts on their Year 1 individual income tax returns. The Family also reported income that they received from annuities in Year 2 on their Year 2 individual income tax returns.

On Date 6, the Corporate Trustee was terminated, effective immediately, as Corporate Trustee for each of the Family Trusts. On Date 7, the corporate trustee was replaced with Trustee, who is represented as being an employee of a corporation in which the stock holdings of the Family are significant from the viewpoint of voting control and/or a subordinate employee of a corporation in which the Family are executives. The power to replace the corporate trustee was exercised by a "trust adviser," who is described as not as not being a related or subordinate party to any Family Trust grantor within the meaning of § 672(c). As a related or subordinate party within the meaning of § 672(c), Trustee's exercise of trustee powers would cause the trusts to become grantor trusts under § 674(a) and (c). The Family Trusts became

grantor trusts due to the replacement of the corporate trustee with a related party. Thus, as of Date 7, the Family directly held partnership interests in Partnership and reported no further annuity income, because, as owners of the trusts, they were both payors and payees on the annuities.

LAW AND ANALYSIS

ISSUE 1

The Family claims that they are able to avoid recognizing income on annuity payments received after the trusts were converted to grantor trusts and hence avoid recognizing gain from the sale of appreciated stock through (1) the Family's sale of low-basis, high-fair market value stock to nongrantor trusts in which they were grantors; (2) the trusts' purchase of this asset with an annuity which allowed the Family to report gain ratably over the duration of the annuity; (3) the conversion of the trusts from nongrantor trusts to grantor trusts; and (4) the rule in Revenue Ruling 85-13, 1985-7 I.R.B. 28 (discussed below) that transactions between a grantor and his grantor trust are disregarded for income tax purposes

Your position for attacking the transaction – that is, to ensure that taxable income is recognized from the sale of the appreciated stock - is to assert that ownership of a trust's assets changes hands when its separate existence for tax purposes disappears on it becoming a grantor trust. Therefore, you argue that because ownership has changed hands, the conversion of a nongrantor trust to a grantor trust is a taxable transaction with respect to both the transferring nongrantor trust and the transferee grantor trust. In the instant case, you observe that each of the nongrantor trusts, the transferors, will recognize little gain on the transfer because their bases in the Partnership interests, acquired by purchase, are roughly equal to Partnership's fair market value. On the other hand, the transferees of the nongrantor trusts' assets (the grantor trusts and the Family as the owners of the grantor trusts) would realize taxable income on the receipt of assets from the Family Trusts.

In support of this argument, you cite to a group of authorities that discuss the tax consequences the conversion of a grantor trust to a nongrantor trust (the reverse situation of the present case). However, even if we were to accept that these authorities apply with equal force to the conversion of a nongrantor trust to a grantor trust, they would not support the position that the new deemed owner of the trust assets will have taxable income from the receipt of trust assets. The primary authorities cited are:

Rev. Rul. 77-402, 1977-2 C.B. 222, which holds that when the grantor and owner of a trust which holds a partnership interest subject to liabilities renounces all grantor trust powers over that trust during life, the grantor is treated as having transferred the interest, and will recognize gain or loss.

Under § 1.1001-2(c), Ex. 5, C, an individual creates T, a grantor trust. C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as the owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. When C renounces the powers that initially resulted in T being classified as a grantor trust, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. Since prior to the renunciation, C was the owner of the entire trust, C was considered the owner of all the trust property for federal income tax purposes and C was considered to be the partner in P during the time T was a grantor trust. When T no longer qualified as a grantor trust, with the result that C was no longer considered to be the owner of the trust and trust property, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity. At that time C's share of P's liabilities is $11,000. On the transfer, C's share of partnership liabilities is considered as money received.

Madorin v. Comm, 84 T.C. 667 (1985) upholds Example 5 of § 1.1001-2(c) on similar facts. The court in Madorin explained the rationale for taxing the grantor: In the instant case there is an interplay between § 671 and the partnership provisions of subchapter K, along with the recognition of gain or loss provisions of § 1001. These sections require the recognition of gain upon the sale or disposition of a partnership interest where the amount realized exceeds the adjusted basis of the partnership interest. The basis of a partnership interest includes partnership liabilities. Sections 722 and 752. As the adjusted basis of the partnership interest is often reduced by partnership losses resulting from depreciation and other write-offs, the goal is to force a recapture upon disposition. This is accomplished by including as amounts realized liabilities previously included in basis to the extent the transferee takes the property subject to those liabilities or assumes them. Crane v. Commissioner, 331 U.S. 1 (1947).

The authorities cited only discuss the application of § 1001 to the party who is considered to have transferred ownership (the "transferor") of trust assets. Regulation 1.1001-2(c), Example 5, Madorin, and Rev. Rul. 77-402 are silent regarding the income tax consequences to the party who receives trust assets (the "transferee"), which in these examples was the nongrantor trust. We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event.

Assuming the transaction in the present case is abusive, asserting that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact on non-abusive situations. A nongrantor trust may become a grantor trust in several situations: examples include the appointment of a related or subordinate trustee to replace an independent trustee as in the present case (§ 674); a borrowing of the trust corpus under § 675(3) (discussed below in ISSUE 2 with regard to the application of Rev. Rul. 85-13); or the payment of the grantor's legal support obligations under § 677(b). No prior guidance dealing with these events has indicated that they result in taxable income to the deemed transferee (the owner of the

grantor trust). Rev. Rul. 85-13 concluded that the grantor became the owner of the trust corpus which he had indirectly borrowed and thus was taxable on the trust's income and, as the deemed owner of the trust assets, could not engage in a transaction with the trust that would be respected for income tax purposes. It did not conclude that the grantor realized the amount of the indirect borrowing or any portion of that amount as income under § 61 or any other section. Therefore, while we agree that this appears to be an abusive transaction, the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor.

ISSUE 2

As an alternative or supplemental argument to treating the transition from nongrantor to grantor trust status as an income tax event to the grantor, you suggest that the Date 3 sale of the partnership interests to the trusts in return for the private annuities should be treated as an indirect borrowing of the trust assets, causing the trusts to become grantor trusts as of that date rather than Date 7, when the subordinate party became a trustee. This would cause the purported sale to be disregarded for income tax purposes, thus vitiating the § 754 election made effective the same date as there would not be a transfer of a partnership interest to which such election could apply. The basis of the stock in the hands of the partnership would retain its low basis (rather than the stepped-up amount of $a) and the difference would be recognized as income to the partnership (and thus the trusts and their owners) as of the Date 5 sale of the stock.

This result depends on the application of Rev. Rul. 85-13 and § 675(3). In that ruling, an individual created a nongrantor trust for the benefit of a child, which was funded with stock. The trustee later transferred the appreciated stock back to the grantor in return for the grantor's unsecured promissory note for the full value of the stock. The grantor later sold the further-appreciated stock to an unrelated party. The ruling concludes that the purported sale was the equivalent of a borrowing from the trust (i.e., that it was economically identical to the grantor having contributed cash and then borrowed the cash in exchange for the unsecured note). Section 675(3) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. This does not apply to a loan which provides for both adequate interest and adequate security.

Rev. Rul. 85-13 additionally holds that the grantor is not only taxable on the income of the trust, but is treated as the owner of the trust's assets for income tax purposes (refusing to follow Rothstein v. U.S., 735 F.2d 704 (2d Cir. 1984), in which the Court held that §§ 671 and 675 were only income-attribution rules and did not otherwise cause the grantor to be treated as the owner of the trust property). Therefore, the purported sale was disregarded, since the grantor was both the maker and owner of the

note, and the basis of the stock remained the same as it had been at the initial contribution.

We do not agree that the facts of the present case are substantially similar to Rev. Rul. 85-13. In Rev. Rul. 85-13, the economic benefit is to the grantor. The economics of the sale in the present case are the opposite of those presented in Rev. Rul. 85-13. The grantor is not acquiring valuable property in return for an unsecured note, but instead is giving up such property in return for an unsecured promise to pay by the trust. If this were recast as a loan, it would be as a borrowing for which the grantor put up collateral equal to the full amount being borrowed. Since this seems to be an unlikely situation for any borrower to enter into, it should not be treated as a borrowing under § 675.

In addition, Rev. Rul. 69-74, 1969-1 C.B. 43, treats the exchange of appreciated property for a private annuity as a sale rather than a borrowing. In that ruling, a father transferred a capital asset having an adjusted basis of $20,000 and a fair market value of $60,000 to his son in exchange for the son's legally enforceable promise to pay him a life annuity of $7,200 per year, in equal monthly installments of $600. The present value of the life annuity was $47,713.08. The ruling concluded that: (1) The father realized capital gain based on the difference between the father's basis in the property and the present value of the annuity; (2) the gain was reported ratably over the father's life expectancy; (3) the investment in the contract for purposes of computing the exclusion ratio was the father's basis in the property transferred; (4) the excess of the fair market value of the property transferred over the present value of the annuity was a gift from the father to the son; and (5) the prorated capital gain reported annually was derived from the portion of each annuity payment that was not excludible.

Please note that we are not opining on the possible applicability of the step transaction, the economic substance doctrine or other judicial doctrines to the transaction in the present case. Nor are we able to determine from the facts presented whether this case is substantially similar to that in Rev. Rul. 69-74. Because the case presents an apparent abuse, however, we would like to explore with you further case development that may lead to other arguments to challenge the transaction.

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Please call Jennifer Keeney of this office at (202) 622-3060 if you have any further questions.