Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201330033**
Release Date: 7/26/2013

CC:PSI:02:
POSTS-103578-11

UILC: 2033.00-00, 2038.00-00, 2512.00-00

date: February 24, 2012

to:

Attorney
(Small Business/Self-Employed)

from: Bradford R. Poston
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subject:

This Chief Counsel Advice responds to your request for assistance dated October 27, 2011. This advice may not be used or cited as precedent.

LEGEND

Date 1 =
Decedent =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Charity =
Y =
Year 1 =
Year 2 =
Trust A =
Trust B =
$ a =
$ b =

$ c =
Z =

[*Note*: In accordance with 26 C.F.R. § 301.6110-3(b), substitutions have been made in this document with respect to certain information deleted pursuant to I.R.C. § 6110(c).]

ISSUES

1. Does all or any portion of the Date 1 transfers of stock from the decedent to the grantor trusts in exchange for the notes with the self-cancelling feature constitute a gift?
2. How should the fair market value of the notes with the self-cancelling feature be determined?
3. If the Date 1 transfers do not constitute a gift, what are the estate tax consequences of the cancellation of the notes with the self-cancelling feature upon the decedent's death?

CONCLUSIONS

1. If the fair market value of the notes is less than the fair market value of the property transferred to the grantor trusts, the difference in value is a deemed gift.
2. The notes should be valued based on a method that takes into account the willing-buyer willing seller standard of § 25.2512-8 and should also account for the decedent's medical history on the date of the gift.
3. In this case, we believe there is no estate tax consequence associated with the cancellation of the notes with the self-cancelling feature upon the decedent's death.

FACTS

Decedent died on Date 2. He was . In the year before he died, decedent revised his estate plan. Under his existing plan, Charity, a charitable organization, was the primary beneficiary of his estate. Under the revised plan, a significantly larger portion of his assets passed to family members rather than to Charity.

At death, the decedent owned a number of assets of substantial value. The decedent also owned stock in Y, a corporation

.

Under the estate plan as in effect prior to Year 1, almost all of the decedent's Y stock was to pass to Charity. In the fall of Year 1, the decedent revised his estate plan so that a larger portion of his interest in Y would pass to his family members, with Charity receiving the residue of his estate. As part of the new estate plan, the decedent established Z separate trusts. The decedent was treated as the owner of each of the Z trusts under the grantor trust rules (§§ 671 et. seq.) (grantor trusts) in addition to grantor trusts that decedent established in the for the benefit of

. By the end of Year 1, the decedent had established separate grantor trusts for the benefit of his family members.

First set of transactions

On Date 3, the decedent funded the Z newly created grantor trusts with common voting and preferred non-voting Y stock. On the same date, just prior to making the transfers, the decedent substituted common and preferred Y shares for preferred shares held by the existing grantor trusts that the decedent had established for the benefit of . The decedent hired appraisers to value the Y stock for purposes of the substitutions and the transfers to the newly created grantor trusts. The appraisal valued common shares at $ per share and the preferred non-voting shares at $ per share. The total appraised value of the stock transferred on Date 3 was $. On , the decedent's estate filed a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, for Year 1 (Year 1 Gift Tax Return). The return reported these and other transfers made in Year 1 and also reported gift and generation-skipping transfer tax in the amount of $.

On , Y declared a $ dividend for each common and preferred share of Y stock. The dividend was payable on or before , to each shareholder of record as of .

Second set of transactions

On Date 4, the decedent substituted preferred and common Y shares for other Y shares held in the previously established grantor trusts for the benefit of family members. On the same date, after the substitutions were complete, the decedent made a gift of Y shares valued at $ to a grantor-retained annuity trust (GRAT), the Trust A, with an annuity term of years. The transfer resulted in a taxable gift of $. Because the decedent died before the end of the GRAT's -year term, the value of the assets was included in the gross estate, and under his estate plan, the assets passed to Charity.

Third set of transactions

Also on Date 4, the decedent transferred Y stock with an appraised value of $ (based on the previously obtained appraised values) to the grantor trusts. In exchange for the Y stock, the decedent received Z promissory notes, each with a -year term. The -year term was based on decedent's life expectancy of years as determined in the tables in the regulations under § 7520.

of the Z promissory notes had face amounts equal to the appraised value of the Y stock that was transferred to the grantor trusts. Each of these notes had an

interest rate of percent. The notes required that the trust make only annual interest payments during the term of the note and further required that the principal be paid on the final date of the term. The total appraised value of the Y stock transferred in exchange for these notes was $ a.

The remaining notes had an interest rate of percent. Like the notes discussed above, each note required only payments of interest during the note term and the payment of principal to the note holder on the last day of the term. These notes, however, differed in one significant way. Each of the notes contained a self-cancelling feature, which effectively relieves the issuer, the grantor trust in this case, of the obligation to make any further payments on the note if the seller, the decedent in this case, dies before all of the payments under the note have come due. According to the Year 1 appraisal, the value of the Y stock that decedent transferred to the grantor trusts was $ b. The total face value of the self-cancelling notes was $ c, almost double the value of the stock. The higher value of the notes supposedly compensated the decedent for the risk that he would die before the end of the note term and neither the principal nor a significant amount, if not all, of the interest would be paid. In fact, the decedent died less than six months after the transfer, and therefore, received neither the interest payments nor the principal due on the notes.

Fourth set of transactions

On Date 5, the decedent transferred stock in Y with an appraised value of $ to the previously established grantor trusts for . In exchange for the stock, the decedent received additional notes with a face value equal to the appraised value of the stock. Like the notes in the transaction above, these notes had a -year term, required only interest payments during the term, and contained a self-cancelling feature. To account for the possibility that the self-cancelling feature would take effect, these notes contained an interest rate of percent. In this case, the decedent died less than six months after the transfers, and therefore, he received neither the interest payments nor the principal due on the notes.

Fifth set of transactions

Also on Date 5, the decedent created the Trust B, a GRAT that had an annuity term of years. The decedent funded this GRAT with shares of Y stock valued at approximately $ and the notes that he received from trust and trust with a face value of $. The decedent reported a taxable gift of only $ as a result of the transfers.

Year 2 gift tax return

On Date 6, the decedent's estate filed a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, for Year 2 (Year 2 Gift Tax Return). The Year 2 Gift Tax Return reported the taxable gifts related to the formation of the GRATs

and also reported gift tax due in the amount of $. The Year 2 Gift Tax Return also reported a number of non-taxable gifts (annual exclusion gifts, marital gifts, and charitable gifts). A statement attached to the Year 2 Gift Tax Return disclosed the third and fourth set of transactions described above but did not report any taxable gift as a result of those transactions.

The decedent's health

Very shortly after the fourth and fifth set of transactions, the decedent was diagnosed with

After diagnosis, he survived for less than six months. He died on Date 2.

The decedent's estate tax return

On Date 7, the decedent's estate filed a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, (the Estate Tax Return). On Schedule G of the Estate Tax Return, the non-self-cancelling promissory notes from the third set of transactions were included at their face values of $ a plus accrued interest. Schedule G of the Estate Tax Return also includes the value of the GRATs created in the second and fifth set of transactions. The Estate Tax Return does not, however, include any portion of the self-cancelling notes executed in the third and fourth set of transactions for Y stock with an appraised value totaling $.

LAW AND ANALYSIS

Issues 1 and 2

Section 2501 of the Internal Revenue Code imposes a tax on the transfer of property by gift. The gift tax applies to all transactions whereby property is gratuitously passed or conferred upon another, regardless of the means or device employed. Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value

of the property exceeded the value of the consideration is deemed a gift that is included in computing the amount of gifts made during the calendar year.

Section 25.2512-4 of the Gift Tax Regulations provides that 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.

Section 25.2512-8 provides, in part, that a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction that is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth.

In general, a transaction where property is exchanged for promissory notes will not be treated as a gift if the value of the property transferred is substantially equal to the value of the notes. The face value and length of payments of the notes must be reasonable in light of the circumstances. To determine whether the gift tax applies, the Internal Revenue Service must determine the value of the Y stock that the decedent transferred to the grantor trusts shortly before his death and the value of the notes taking into consideration the notes' self-cancelling feature. If the fair market value of the notes is less than the fair market value of the property transferred to the grantor trusts, the difference in value is deemed a gift. Section 2512(b) and § 25.2512-8.

In Estate of Costanza v. Comm'r, 320 F. 3d 595 (6th Cir. 2003), rev'g T.C. Memo 2001-128, the decedent sold real property to his son, in exchange for a note with a self-cancelling feature (SCIN) that was fully secured by a mortgage on the property. The note provided for monthly installments over a period of 11 years and for the payment of interest at a rate that increased every 24 months. The initial interest rate was 6.25 percent, and the rate increased by one half percent at each 24-month interval, until reaching a final rate for the last 12 months of 8.75 percent. The note also provided that, if decedent died before the principal and interest had been paid, it would be canceled and no more payments would be required. The decedent died unexpectedly five months after the issuance of the note. The appellate court stated that, "a SCIN signed by family members is presumed to be a gift and not a bona fide transaction." Id. at 597. The appellate court stated that the presumption may be rebutted by an affirmative showing that there existed at the time of the transaction a real expectation of repayment and intent to enforce the collection of the indebtedness. The court concluded that, on the facts before it, the presumption had been rebutted. The decedent was not willing to gift the business properties to his son because he required a steady stream of income in order to retire. In addition, the taxpayer could show that, at the time of the transaction, a real expectation of repayment existed and decedent

intended to enforce the collection of the indebtedness. Therefore, there was a bona fide transaction.

In Estate of Costanza, the Service argued, in the alternative, that the transaction constituted a bargain sale, a sale for less than the fair market value. The Service argued that the note had considerably lesser value than the property for which it was exchanged, and the difference between the value of the real property and the value of the note constituted a gift. The taxpayer, relying on § 20.2031-4, argued that the fair market value of the note is presumed to be the amount of the unpaid principal, plus interest accrued to the date of death. The court remanded the action to the Tax Court and the parties settled. Thus, Estate of Costanza does not preclude a bargain-sale argument.

This case is distinguishable from Estate of Costanza. In Estate of Costanza, had the decedent lived, he would have received monthly payments consisting of income and principal throughout the term of the note. The decedent required the payments for retirement income and, thus, had a good reason, other than estate tax savings, to enter into the transaction. In contrast, the decedent in this case structured the note such that the payments during the term consisted of only interest with a large payment on the last day of the term of the note (balloon payment). Thus, a steady stream of income was not contemplated. Moreover, the decedent had substantial assets and did not require the income from the notes to cover his daily living expenses. The arrangement in this case was nothing more than a device to transfer the stock to other family members at a substantially lower value than the fair market value of the stock.

In addition to the foregoing, we believe that the notes lack the indicia of genuine debt because there must be a reasonable expectation that the debt will be repaid. Cf. Estate of Costanza; Estate of Musgrove v. United States, 33 Fed. Cl. 657 (1995). The estate must demonstrate that the trust that issued the note has the ability to repay the amount of the note. In the third set of transactions, the trust received stock valued at $ b in exchange for a note the face amount of which was $ c, a difference of approximately $

The reasonable expectation requirement also applies to the notes issued in the fourth set of transactions. We are aware, however, that the decedent funded the grantor trusts with approximately $ b during the first set of transactions although it is unclear how much of this amount was allocated to the various trusts. Thus, the estate may argue that there was sufficient seed money that can be applied to reduce the debt and avoid any argument that the notes are not bona fide (i.e., the trust has sufficient assets such that it can repay the loan).

In this case, the value of the notes was based upon the § 7520 tables. A term of years was chosen because it was determined that the decedent had a year life

expectancy. The decedent accounted for the self-cancellation mechanism by adjusting the principal to be repaid or the interest rate that applied to the principal. Specifically, in the third transaction, the face value of the notes with the self-cancelling feature was approximately $ c and the Y stock exchanged in return for the notes was valued at $ b. In the fourth transaction, a higher interest rate was charged to account for the higher risk that pertained to the self-cancelling feature.

We do not believe that the § 7520 tables apply to value the notes in this situation. By its terms, § 7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in § 25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account. I.R.S. Gen. Couns. Mem. 39503 (May 7, 1986).

Issue 3

Section 2033 provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.

Section 2038 provides that the value of the gross estate includes the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.

In Estate of Moss v. Comm'r, 74 T.C. 1239 (1980), acq. in result, 1981-2 C.B. 1, the decedent sold stock and other property to Moss Funeral Homes, a corporation of which he was the president. In return, the decedent received three promissory notes issued by the corporation. The notes contained a cancellation clause providing that the principal and interest due on the notes would cancel on the decedent's death. The notes provided for interest and equal monthly payments over a period of approximately nine and one-half years. At the time of sale, the physical and mental condition of the decedent was average for a man of 72 years of age. There was nothing to indicate that his life expectancy would be shorter than the approximate ten years of life expectancy that was indicated by generally accepted mortality tables. Only eight months after the sale, the decedent discovered that he had cancer and died approximately ten months later. The Tax Court held that the notes were not included in the decedent's estate because the parties had stipulated that the sales of shares of the notes were bona fide

transactions for full and adequate consideration and that the cancellation provision was part of the bargained for consideration provided by the decedent for the purchase price of the stock. In addition, there was no reason to believe that the decedent's life expectancy would have been shorter than the ten years of life expectancy indicated by the mortality tables.

In Estate of Musgrove v. United States, 33 Fed. Cl. 657 (1995), the United States Court of Federal Claims addressed the issue of whether a transfer by the decedent to his son, less than one month before the decedent's death, in exchange for an interest free demand note with a cancellation on death provision was bona fide. The decedent in Estate of Musgrove was an 84 year old man suffering from angina, arteriosclerosis and hypertension. The decedent's son needed to borrow money to satisfy a debt of his sister's estate, and decedent offered to loan the funds to his son in exchange for a demand note with a cancellation upon death provision. When consummating the transaction, the decedent indicated that he did not believe he would ever need to make a demand for repayment. The son indicated that he did not know if or when he could ever repay the debt. The trial court held that the transaction was not bona fide, since the note was unsecured, the parties failed to schedule regular payments, and the note provided for no interest. The court indicated that the decedent retained an interest in the amount transferred because he maintained possession of the note until his death and had not made a demand for payment on the note. Furthermore, son could not use the money for any purpose other than to pay the debt on his sister's estate, and therefore, decedent had maintained control over the money. The court held that the amount should be included in the decedent's estate under §§ 2033, 2035, and 2038.

There are similarities between the decedent in the subject case and the decedent in Estate of Musgrove. In each case, the decedent who received a promissory note with a self cancelling feature was in very poor health and died shortly after the note was issued. In addition, there is a legitimate question as to whether the note would be repaid in each case.

CONCLUSION

In this case, decedent transferred stock with a purported value of $ b in exchange for notes with a value of $ c that contained a cancellation feature if the decedent failed to survive the -year term of the note. The note also contained a balloon payment feature that pushed a significant portion of the payment to the end of the term. Because of the decedent's health, it was unlikely that

the full amount of the note would ever be paid. Thus, the note was worth significantly less than its stated amount, and the difference between the note's fair market value and its stated amount constitutes a taxable gift.

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