Planning for the Interest Charge on Installment Sales: Decanting a Grantor Trust?

By Louis Vlahos

The Issue

I recently encountered an interesting situation in which someone suggested that a grantor trust be decanted into a non-grantor trust before the end of the taxable year. The reason? To avoid the special interest charge that would otherwise be imposed with respect to the deferred tax liability attributable to the trust's share of an installment obligation.[1]

The trust's principal asset was a membership interest in an LLC that was treated as a partnership for purposes of the federal income tax. Among the assets held by the partnership was an installment obligation that had been received by the partnership earlier in the taxable year in exchange for the partnership's sale of unimproved real property.

In order to appreciate the issue presented, it may be helpful to first take a short walk through the installment sale rules.

The Installment Method

Let's start with the obvious. When a taxpayer sells property in exchange for cash,[2] the taxpayer must recognize, and include in their gross income for the taxable year of the sale, an amount equal to the gain realized from the sale, which is determined by subtracting the taxpayer's adjusted basis for the property (basically, their unreturned investment) from the amount of cash received.[3] Simple.

Of course, many sellers would prefer to defer[4] the recognition of gain in order to take advantage of the time value of money.[5] This may be accomplished by agreeing that the buyer will defer to a subsequent taxable year the payment of at least some of the purchase price.[6] The amount of gain from the sale that is attributable to the amount of the deferred payment will be recognized by the seller when the payment is actually or constructively received, or when it is deemed to have been received, by the seller.[7]

This method of deferring the recognition of gain from a sale is referred to as the installment method and it applies to both cash basis and accrual basis taxpayers.[8] Gain from the sale of property where any payment is to be received in a taxable year after the year of sale must be reported on the installment method unless (i) the Code excludes the property in question from the installment method,[9] (ii) the taxpayer elects not to apply the installment method,[10] or (iii) the taxpayer monetizes or "disposes" of their right to the deferred payments.[11]

Now, let's turn to the interest charge mentioned above.

The Interest Charge

Assuming the selling taxpayer can get comfortable with the credit risk of deferring receipt of the buyer's payment of some portion of the price,[12] the taxpayer will successfully defer payment of a portion of the tax arising from the sale.

In addition, in most cases in which the amount of the deferred payment is fixed or known and is payable according to a schedule, the buyer will be required to pay interest to the seller in respect of the unpaid portion of the price.[13] Of course, the interest will be included in the seller's ordinary income for the year in which it is received.[14]

Notwithstanding the buyer has not paid the full amount owing to the seller in connection with the sale of the property, the buyer is allowed to take the property with a cost basis.[15] In the case of certain property, that means the buyer may begin to recover their purchase price for the property through deductions for depreciation or amortization[16] even before they have paid the full amount. Moreover, the buyer's interest payments may also be deductible.[17]

This is all well and good for the selling taxpayer, and even the buyer, but what about the government? By deferring receipt of the taxes arising from the sale, isn't the government effectively financing the parties' purchase and sale transaction?

To some extent, yes. Enter the special interest charge.

Under the interest charge rule, a selling taxpayer is required to pay interest on a portion of the deferred tax liability with respect to an installment obligation received in exchange for the seller's property.[18]

The rule applies to an installment obligation received by the seller from the buyer during the taxable year of the sale, provided the obligation remains outstanding as of the close of such taxable year and, provided further, that the face amount of such obligation that remains outstanding as of the close of such taxable year exceeds $5 million.[19]

If a selling taxpayer is required to pay interest[20] with respect to an installment obligation in accordance with this rule, then the taxpayer will be required to pay interest for every subsequent taxable year at the close of which any part of that obligation remains outstanding.[21]

The amount of interest payable for a taxable year with respect to an installment obligation to which the special interest rules apply is determined by applying the tax deficiency rate[22] to the amount of the deferred tax liability attributable to that portion of the obligation in excess of $5 million.[23]

The deferred tax liability for a taxable year with respect to such an installment obligation is determined by multiplying (i) the amount of the unrecognized gain attributable to the obligation as of the close of the taxable year, by (ii) the maximum rate of tax applicable to the taxpayer for that year.[24]

Applying the Interest Charge to Passthroughs

In the case of an individual or a C corporation seller, it is clear to whom the special interest charge rules will apply—the seller.[25]

In the case of a passthrough entity, however, the IRS has determined that

> the $5 million threshold is applied, and interest calculations are made, at the owner level. Therefore, . . . [a] passthrough entity shall provide its owners with information needed to calculate the amount of interest on deferred tax liability . . . , including the owner's share of the amount of gain that has not been recognized by the entity as of the close of the passthrough entity's taxable year and the face amount of each of the entity's nondealer obligations outstanding as of the close of the passthrough entity's taxable year.[26]

Thus, in the case of a partnership that has sold property in exchange for an installment obligation, the $5 million threshold is applied, and the interest charge is calculated, at the partner level rather than at the partnership level.[27]

This is consistent with the concept that the character of any item of partnership income, gain, loss, deduction, or credit included in a partner's distributive share is determined as if such item were realized directly from the source from which realized by the partnership or incurred in the same manner as incurred by the partnership.[28]

For example, if a partnership with three equal and unrelated partners sells property in exchange for a $15 million installment obligation, each partner will be treated as owning one third of such obligation, with a face amount of $5 million; thus, none of the partners will be subject to the special interest charge.

The Grantor Trust

However, the IRS has ruled that if a "grantor trust"[29] holds a partnership interest, the grantor of the trust is treated as owning such interest; as a result, the grantor rather than the trust is considered to be the partner for federal income tax purposes.[30]

Thus, where a taxpayer-grantor owns an interest in a partnership, and a trust—of which the taxpayer is treated as the owner under the grantor trust rules—that was created and funded by the grantor for the benefit of the grantor's children owns another interest in the same partnership, the taxpayer-grantor and the trust are treated as a single taxpayer for tax purposes.

Consequently, in the example, above, the taxpayer-grantor would be treated as owning two thirds of the installment obligation received by the partnership in the sale, with a face amount of $10 million, and would be subject to the special interest charge.

It should follow that when the trust ceases to be a grantor trust, the partnership interest is deemed to be transferred from the grantor to the trust.[31]

Indeed, under the facts of the IRS ruling, referenced above,[32] when the grantor renounced the powers that gave rise to the trust's status as a grantor trust, the trust ceased to be treated as a grantor trust and, instead, became a separate taxable entity; as a result, the grantor was no longer considered to be the owner of the partnership interest held by the trust. In fact, the grantor was considered to have transferred ownership of the partnership interest to the trust.

Moreover, the ruling went on to explain that the deemed transfer of the partnership interest by the grantor may be treated as a sale by the grantor if the grantor's share of partnership liabilities was reduced or eliminated as a result of the transfer.[33]

Based on the foregoing, if the partner-grantor of a grantor trust realized before the end of the taxable year in which the partnership transacted an installment sale that they would be subject to the special interest charge because of the grantor's deemed ownership of a partnership interest held by the trust, could the grantor avoid the special interest charge by causing the trust to cease being treated as a grantor trust before the end of the year, on the theory that neither the grantor nor the trust would be treated as owning a share of the installment obligation with a face amount in excess of $5 million as of the close of such taxable year?

Stated differently, if a grantor-partner "transferred" their partnership interest to a non-grantor trust, can they bring themselves below the $5 million threshold for application of the special interest charge while also keeping the trust beyond the reach of the rule?

Is there support for this "strategy"? Perhaps in the case of an interspousal transfer, as discuss below, but not on the facts set forth herein.

Disposition of the Installment Obligation

In general, the disposition of an installment obligation will result in the recognition of the deferred gain. Where the disposition is made other than by a sale or exchange, the gain is equal to the difference between the fair market value of the obligation at the time of the disposition and the basis of the obligation, which is equal to the excess of the face value of the obligation over the amount of gain that would have to be reported if the obligation were satisfied in full.[34]

For purposes of the above "acceleration of gain recognition" rule, a gift of the installment obligation is treated as a "disposition" within the meaning of the rule.

Moreover, according to the IRS, a gift of an interest in a partnership that holds an installment obligation is treated as a disposition of the donor's share of the installment obligation, thereby triggering recognition of the otherwise deferred gain.[35]

Thus, it appears that any post-sale, pre-year-end "re-titling" of ownership of the installment obligation is doomed to fail, even where a principal purpose for the transfer may not have been tax-motivated.

Spouses

There is, however, an important exception to this disposition rule. Specifically, a transfer of an installment obligation between spouses (whether directly or indirectly) is not treated as a disposition that accelerates the recognition of gain, provided the transfer is not made in trust[36] for the benefit of the transferee spouse. In that case, the same tax treatment with respect to the transferred installment obligation will apply to the transferee as would have applied to the transferor-spouse.[37]

In addition, the IRS has advised that, for purposes of applying the special interest charge rule, spouses are treated as separate taxpayers and should be entitled to apply the $5 million limitation to installment obligations that each separately holds regardless of how they file.[38]

According to the Service, each spouse would enjoy a separate $5 million limitation even where originally only one spouse held the installment obligation—or held an equity interest in the passthrough entity that owned the obligation—but made a gift of a portion of such obligation or of the equity in the pass-through entity to the other spouse simultaneously with the sale of the assets in exchange for which the obligation was received, provided the transfer to the other spouse "was a bona fide transaction [which] should, in fact, be respected for federal income tax purposes."[39]

Decanting

Returning to our facts—a grantor trust for the benefit of the grantor's children—would a decanting of the grantor trust into a non-grantor trust succeed in bringing the grantor's share of the installment obligation received by the partnership below the $5 million threshold before the end of the year of the sale? Would the IRS treat a decanting as something other than a disposition for purposes of the installment sale rules?

The answer should be "no."

For the same reasons discussed above, upon the termination of the trust's status as a grantor trust, the grantor is treated as having transferred to the trust the assets held by the trust, including the interest in the partnership holding the installment obligation.

Should the result be different where the grantor trust status is lost because the grantor affirmatively renounced their powers with respect to the trust as opposed to where the trustee exercised their discretion (i.e., without the grantor's involvement) to decant the grantor trust into a non-grantor trust?

Probably not. In both cases, the grantor should be treated as having made a transfer to a "newly formed" trust.

Should it matter whether there was "consideration" for the transfer—as in the case of a shift in the share of partnership liabilities—or not?

Again, probably not. The fact remains that the grantor is treated as having made a transfer, or disposition, to a "newly formed" trust. In fact, in the absence of any consideration, it is reasonable to assume that the grantor's original donative intent[40] from the time the trust was funded should also characterize the transfer that is completed when the trust ceases to be a grantor trust.

What To Do?

At this point, the IRS has not said very much with respect to the tax treatment of decanting a trust. In 2011, the IRS announced that it was studying the tax implications of decanting, was considering approaches to addressing some of the relevant tax issues and invited comments from the public regarding the tax consequences.[41]

Since then, the IRS has avoided ruling on most tax issues relating to decanting, at least where there is a change in beneficial interests.[42]

It remains unclear when we may expect to get answers to the above questions.

That said, the best time to plan for avoiding the special interest charge is well before the sale of the property in exchange for which the installment obligation is to be received, not afterward.

The foregoing discussion indicates that taxpayers may, for purposes of the special interest charge rule, "adjust" their ownership interests in a passthrough entity—for example, by transfer of the interest—so as to reduce their share of an installment obligation received by the entity in exchange for the nearly contemporaneous sale of its assets. However, the means by which this is effectuated must represent a bona fide transaction.

The renunciation of one's grantor trust powers[43]—and the deemed transfer resulting therefrom—before such a sale should also be effective to give the "new" non-grantor trust its own $5 million threshold for purposes of applying the special interest charge rule, in addition to the one enjoyed by the grantor.[44]

The distribution of a partnership interest to a beneficiary of the trust prior to a sale should have the same beneficial outcome, provided the distribution represents a bona fide transfer.

Query whether the amendment of a partnership agreement with respect to the year of the sale subsequent to the close of such taxable year (but not later than the date prescribed by law for the filing of the partnership return, not including not including any extension) would be effective.[45]

Finally, it should be noted that the IRS is authorized to issue regulations with respect to the application of the interest charge rule to passthrough entities, including partnerships.[46] To date, no such regulations have been issued, but I imagine that the tailoring of partners' interests in a partnership for the purpose of avoiding the interest charge would certainly be on the agenda for such a regulation.

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Endnotes

1 IRC Sec. 453A.

2 Which may also include the buyer's assumption of a liability of the seller.

3 IRC Sec. 1001; Reg. Sec. 1.1001-1.

4 What do you call alliteration on the back end? Assonance. Get it? Seriously. I didn't make it up.

5 Specifically, the use of the amount of income tax that would otherwise be payable.

6 The buyer's obligation to pay the deferred portion of the price according to a fixed schedule may be evidenced by the purchase and sale agreement or by a promissory note.

There is an inverse relationship between economic security and the incidence of taxation. If a selling taxpayer receives payment in the year of the sale, it is appropriate to tax them at that time. If the payment is deferred so that the seller has some credit risk, the imposition of tax is deferred until the payment is received.

Taxpayers have long sought to have their cake and eat it too. Of course, they may take a security interest in the property sold, but what will it be worth at the time the buyer defaults on a payment?

In the end, Congress and the IRS have decided that neither a third-party guarantee of the buyer's payment obligation nor the issuance by a bank of a standby letter of credit to secure such obligation will accelerate the recognition of gain by the seller. IRC Sec. 453(f); Reg. Sec. 15A.453-1(b)(3)(iii).

7 IRC Sec. 453. Thus, a seller who defers the receipt of two thirds of the purchase price until the first and second anniversaries of the sale will recognize one third of the gain in the year of the sale and one third in each of the next two years.

However, the recognition of the deferred gain may be accelerated where the seller is deemed to have received a payment. For example, where the seller pledges the installment obligation to secure a loan, or where the seller disposes of the installment obligation. IRC Sec. 453A and Sec. 453B, respectively.

Likewise, where the seller receives an obligation that is payable on demand or that is readily tradable. IRC Sec. 453(f)(4).

8 There was a brief period during which the installment method would have been denied to accrual basis taxpayers as a result of an amendment by the Tax Relief Extension Act of 1999 (P.L. 106-170). This ill-conceived change was reversed retroactively by the Installment Tax Correction Act of 2000 (P.L. 106-573). Thus, the 1999 amendment never took effect.

9 For example, the installment method is denied to sales by dealers and to sales of inventory, to the ordinary income from depreciation recapture, and to the sale of stock or securities that are traded on an established securities market. IRC Sec. 453(b), Sec. 453(i), and Sec. 453(k), respectively.

10 IRC Sec. 453(d). The election must be made on or before the due date (including extension) for filing the tax return for the year of the sale. Many taxpayers who sold assets during 2021 arranged to receive an installment obligation payable in 2022. The reason? In case Congress increased the tax rate on long-term capital gains effective in 2022, the selling taxpayers preserved the ability to elect out of installment reporting and include the gain in their income for 2021 when it would have been taxable at a more favorable rate.

11 IRC Sec. 453A and Sec. 453B. https://www.taxslaw.com/2021/05/cash-in-hand-tax-deferral-monetized-installment-sales-no-you-cant-have-it-all.

12 For example, the guarantee of the financially sound parent company that owns the buyer, or a standby letter of credit issued by a bank; because the latter represents an obligation from the bank to the seller, it cannot be reached by the buyer's other creditors in the event of the buyer's bankruptcy, provided it is not somehow treated as an item of preference.

13 The interest is intended to compensate the seller for the deferred receipt of the price. The longer the deferral period, the greater the rate of interest.

Interestingly, as a practical matter, one rarely sees interest charged with respect to a contingent payment such as an earnout. The imputed interest rules are nonetheless applicable.

14 IRC Sec. 61. The failure to charge adequate interest (at least at the AFR) may trigger application of the imputed interest rules under IRC Sec. 1274 or Sec. 483.

15 IRC Sec. 1012.

16 IRC Sec. 167, Sec. 168, and Sec. 197. In the case of certain tangible personal property, the buyer would be allowed to expense the amount of consideration allocated to such property. IRC Sec. 168(k).

17 IRC Sec. 163.

18 IRC Sec. 453A(a)(1).

19 IRC Sec. 453A(b)(2).

20 In the case of an individual taxpayer, the interest should be treated as nondeductible personal interest. Reg. Sec. 1.163-9T(b)(2)(i)(A).

21 H.R. Rep. No. 100-495, at 929 (1987). Thus, even if the amount that remains outstanding under the obligation has dropped below $5 million, the interest charge will still apply.

22 The IRS just announced that such interest rates will increase for the calendar quarter beginning Oct. 1, 2022. For individuals, the rate for underpayments will be 6% per year, compounded daily, up from 5% for the quarter that began on July 1. Rev. Rul. 2022-15.

23 IRC Sec. 453A(c)(4).

Specifically, the "applicable percentage" of the deferred tax liability is multiplied by the underpayment rate in effect for the month in which the taxable year ends. IRC Sec. 453A(c)(2).

The "applicable percentage" with respect to an obligation means the percentage determined by dividing (i) the portion of the face amount of such obligation outstanding as of the close of the taxable year in excess of $5 million by (ii) the face amount of the obligation arising in and outstanding at the close of such taxable year. This percentage does not change over the term of the obligation.

24 IRC Sec. 453A(c)(3).

When the gain recognized by an individual taxpayer is treated as long-term capital gain, the preferred 20% federal capital gain rate would apply.

25 Thank you, Captain Obvious.

26 IRS Notice 88-81. The Notice defines "passthrough entities" as partnerships, S corporations, and trusts. Thus, in the case of the two business entities, the owners to which the Notice refers should include the partners and shareholders, as the case may be.

That makes sense in the case of an S corporation that has not sold property that is subject to the IRC Sec. 1374 built-in gain rules; in that instance, shouldn't the interest charge be applied at the level of the corporation, notwithstanding that the after-tax amount is passed through to the shareholders under IRC Sec. 1366?

What about a trust and its beneficiaries? Unlike the partnership and the S corporation, the non-grantor trust is a taxpayer and only avoids the payment of income tax with respect to a taxable year by making a distribution of its distributable net income for the year to its beneficiaries, who are then required to include such income on their own tax returns.

27 The same reasoning should apply to a situation involving a tiered partnership.

28 IRC Sec. 702(b).

29 Under IRC Sec. 671 et seq., if a grantor holds certain rights or powers with respect to the trust, the grantor will be treated as owning the trust's property and income. Among the rights or powers that would cause the trust to be treated as owned by the grantor is the grantor's power, acting in a nonfiduciary capacity and without the consent of any fiduciary, to reacquire trust property by substituting other property of equivalent value. IRC Sec. 675(4). Another means by which a trust will be treated as owned by the grantor is if the trust's income, without the approval or consent of any adverse party, is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse. IRC Sec. 677(a).

30 Rev. Rul. 77-402.

31 Reg. Sec. 1.1001-2(c), Ex. 5.

32 Rev. Rul. 77-402.

33 Under IRC Sec. 752(d), the amount of the reduction in the grantor's share of the liability would be treated as consideration received in the exchange. *See also* Reg. Sec. 1.1001-2(c), Ex. 5.

34 IRC 453B.

35 Rev. Rul. 60-352.

36 The limitation for a transfer in trust seems to assume that the remainder interest belongs to someone other than the spouse.

37 IRC Sec. 453B(g). See IRC Sec. 1041.

38 TAM 9853002. Inexplicably, and basically as dicta, the IRS added: "This result is even more warranted in the present case where [the spouses] filed separate tax returns." Go figure.

39 TAM 9853002. For example, where the donee spouse continues to own the note or the equity received from the donor spouse, and continues to enjoy the economic benefits arising from the ownership thereof, shouldn't the transfer be respected for tax purposes?

40 An element of gift status for income tax purposes. Contrast Reg. Sec. 25.2511-1(g): "Donative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer." Of course, the grantor trust rules apply only for purposes of the income tax.

41 IRS Notice 2011-101.

42 *See* Rev. Proc. 2022-3, Sec. 5, in which the IRS states that the tax treatment of decanting is under study for most income and transfer tax purposes. You will also note in many PLRs that the IRS has been careful to state that it was not expressing an opinion regarding the tax consequences of a trust decanting.

43 Or in the case of a QSST, its conversion to an ESBT. *See*, e.g., Rev. Proc. 98-23, Sec. 4.

44 Though a grantor must be careful of being treated as having received consideration, thereby triggering a sale. *See* Rev. Rul. 77-402 and Reg. Sec. 1.1001-2(c), Ex. 5.

45 Reg. Sec. 1.761-1(c).

46 IRC Sec. 453A(c)(6).