

## Taxes - IRS Puts Taxpayers on Notice - Beware “Toggle Trusts”

In Notices 2009-55 and 2009-59, IRB 2009-31, August 3, 2009, the IRS reminded taxpayers that certain “toggle trusts” (and substantially similar transactions) continue to be considered “transactions of interest.” Designating the listed transactions as “transactions of interests” imposes obligations on taxpayers and their advisors under pain of penalties for non-compliance.

### Background—Transactions of Interest

In the “old days” taxpayers engaging in sophisticated tax strategies were not generally required to disclose such strategies on their tax returns, so long as they had an opinion from a tax professional concluding that the strategies were “more likely than not” to withstand scrutiny.

The regulatory framework underwent change in 2000 when the IRS issued temporary regulations under section IRC 6011 requiring taxpayers to disclose various transactions that in the IRS’s view were potentially abusive. These transactions are referred to in the regulations and in subsequently enacted legislation as “reportable transactions.”

The final regulations, promulgated in 2003, are both broader in scope and stricter than the temporary regulations. In the final regulations, taxpayers participating in “reportable transactions” must disclose such transactions on their returns. Furthermore, disclosure is required regardless of whether the taxpayer’s intent when entering into the transaction is improper tax avoidance. The regulations acquired “teeth” when the American Jobs Creation Act of 2004 (AJCA) created several new penalties, and enhanced already-existing penalties, for failures to report reportable transactions as required under the final section regulations.

For purposes of the final regulations, the term “reportable transaction” includes “listed transactions.” These are transactions the IRS has identified as having the potential for tax abuse.

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The IRS notifies taxpayers and their advisors of listed transactions through the issuance of notices contained in Revenue Bulletins.

### **Notice 2007-73**

Toggle trusts typically arise in the context of grantor trusts. A grantor trust is a trust under which trust income and loss flow through to the grantor by virtue of the grantor retaining certain powers under IRC Section 671-679. For example, a grantor retaining the right to revoke a trust will be responsible for trust income and loss under IRC Section 676.

In some instances, advisors find it advantageous to toggle grantor trust status on and off, using sophisticated drafting techniques. The IRS takes a jaundiced view of toggle trusts when the goal is to avoid recognition of trust income at one point in time, while enjoying the benefit of trust losses at another point in time.

The IRS's concern first surfaced with Notice 2007-73. Specific facts were as follows:

#### *Situation 1*

1. Grantor purchases four options. The value of each of the options is expected to move inversely in relation to at least one of the other options over a relevant range of values so that, before expiration of any one of the options, there would be a gain in two options (gain options) and a substantially offsetting loss in the other two options (loss options).
2. Grantor creates a trust and funds it with the options and a small amount of cash.
3. Grantor transfers a short-term unitrust interest in the trust to the beneficiary and retains a non-contingent remainder interest in trust. The remainder interest is structured to have a value as determined under IRC Section 7520 that equals the fair market value of the options. Grantor takes the position that the grantor's remainder interest is a qualified interest under Code Section 2702. Due to the retained remainder interest, the grantor treats the trust as a grantor trust. The trust agreement also provides that the grantor will have the power, exercisable in a non-fiduciary capacity, to reacquire trust corpus by substituting other property of an equivalent value (and that this substitution power will become effective on a specified date in the future).
4. After establishing and funding the trust, Grantor sells the remainder interest to an unrelated person (Buyer) for an amount equal to the fair market value of the remainder interest (the fair market value of the options). Grantor claims that the basis in the remainder interest is determined by allocating to the remainder interest a portion of the basis in all of the trust assets (based on the respective fair market values of the remainder and unitrust interests at the time of the sale). Therefore, Grantor claims there is no gain

recognized on the sale of the remainder interest because grantor's basis in the remainder interest is the same as the amount realized.

5. Grantor receives from Buyer an installment obligation, cash, or other consideration for the remainder interest. Grantor claims that the sale of the remainder interest has terminated (toggled off) the grantor trust status of the trust so that, during the period after the sale and before the effective date of the substitution power, trust is no longer a grantor trust under Code Section 671. Grantor claims that, once the substitution power becomes effective again, grantor trust status is restarted (toggled on).
6. The loss options are then closed out. The amount Grantor paid for those options (the original basis of those options) is greater than the amount the trust receives when the loss options are closed out. Grantor claims that trust's status as a grantor trust causes Grantor to recognize the loss on the two loss options. Grantor calculates the loss based on the difference between the amount realized and the original basis in the loss options, even though Grantor previously used a portion of the basis in the trust assets (equivalent to the basis in all of the options) to eliminate gain on the sale of the remainder interest. Trust's remaining assets then consist of the two gain options, the contributed cash, and amounts received, if any, upon the termination of the loss options.
7. Buyer then purchases the unitrust interest in Trust from Beneficiary for an amount equal to the actuarial value of that interest (which equals or approximates the amount of cash Grantor contributed to Trust), making Buyer the owner of both the remainder interest and the unitrust interest.
8. Trust then terminates (by operation of law or Buyer's action), and trust assets are distributed to Buyer. Buyer claims a basis in the assets (the gain options and the cash) from Trust equal to the amount paid by Buyer for the two separate interests in Trust.

*One of the purported tax consequences of the first variation of the transaction is that Grantor sells the remainder interest and receives an amount substantially equal to the fair market value of the (non-cash) assets contributed to Trust but nevertheless claims a tax loss attributable to those assets even though Grantor has not suffered an equivalent economic loss.*

9. Grantor does not treat the termination of the trust as a taxable disposition by Grantor of the assets of the trust. The gain options are exercised or sold, or otherwise terminate, and Buyer claims to recognize gain on the gain options only to the extent that the amount realized exceeds the basis Buyer allocates to the gain options. The transaction has been structured so that any gain recognized is minimal. If Buyer purchased the remainder interest from Grantor with an installment obligation, Buyer uses the proceeds from the options to satisfy the obligation. If Grantor borrowed to purchase the options, Grantor repays the loan from the sale proceeds.

One of the purported tax consequences of the first variation of the transaction is that Grantor sells the remainder interest and receives an amount substantially equal to the fair market value of the (non-cash) assets contributed to Trust but nevertheless claims a tax loss attributable to those assets even though Grantor has not suffered an equivalent economic loss.

*Situation 2:*

In another variation of the transaction, the facts are the same as described above except for the following.

1. Grantor contributes liquid assets such as cash or marketable securities to the trust, rather than options. Grantor's basis in the contributed assets equals or is approximately equal to the fair market value of the assets at the time of contribution.
2. Before the specified date on which Grantor's substitution power becomes effective, Grantor sells the remainder interest in the trust to Buyer for an amount equal to the fair market value of the remainder interest and claims to recognize no gain or a minimal gain or loss for the same reason as described above. As in the prior situation, Grantor claims that the sale terminates (toggles off) the trust's grantor trust status.
3. After the substitution power becomes effective, Grantor substitutes appreciated property for the trust's liquid assets. The fair market value of the substituted property is equivalent to the fair market value of the liquid assets. Grantor claims that, once the substitution power becomes effective (prior to the exchange), the trust's grantor trust status is restarted (toggled on), and, therefore, the substitution will not cause Grantor to recognize gain.
4. As described above, Buyer purchases the unitrust interest in the trust from the designated beneficiary, terminates the trust, and receives trust assets on distribution. For tax purposes, Grantor does not treat the termination of the trust as a disposition by Grantor of the appreciated assets in the trust. Buyer claims a basis in the trust assets (the appreciated property and cash) equal to the amount paid by Buyer for the interests in the trust.

One of the purported tax consequences of the transaction is that Grantor avoids the recognition of gain on the disposition of the appreciated assets substituted for the original assets contributed to Trust.

The transactions described in both transactions are designed to occur within a short period of time during the taxable year (typically within 30 days).

Although the Notice does not say, presumably the IRS would challenge the transactions on the basis of “substance over form,” the argument being that by merely manipulating the form of the transaction (all of which is within the taxpayer’s apparent control) favorable tax results are achieved that would not otherwise be available.

### **Bottom Line**

The issuance of Notice 2009-55 reminds of us of the following:

- The “new” regulatory format makes it increasingly difficult for taxpayers to engage in sophisticated tax strategies without notifying the IRS of their activities.
- The IRS remains vigilant for transactions that enable taxpayers to manipulate the amount and/or timing of the amount of gain or loss.

Furthermore, it is worth noting that while the new notice reminds taxpayers of the transactions listed in Notice 2007-73, the IRS has not changed the scope of the listed transaction.

Consequently, toggle provisions that do not turn off and on, but merely turn off (as is the case in the typical “Intentional Grantor Defective Trust” (IGDT) should fall outside the scope of the Notice. IGDTs are discussed in more detail in this month’s Cannon Insights: Planning Ideas.

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