

Part III - Administrative, Procedural, and Miscellaneous

Transaction of Interest – Toggling Grantor Trust

Notice 2007-73

The Internal Revenue Service and the Treasury Department are aware of a type of transaction, described below, that uses a grantor trust, and the purported termination and subsequent re-creation of the trust's grantor trust status, for the purpose of allowing the grantor to claim a tax loss greater than any actual economic loss sustained by the taxpayer or to avoid inappropriately the recognition of gain. The IRS and Treasury Department believe this transaction has the potential for tax avoidance or evasion, but lack sufficient information to determine whether the transaction should be identified specifically as a tax avoidance transaction. This notice identifies this transaction, and substantially similar transactions, as transactions of interest for purposes of § 1.6011-4(b)(6) of the Income Tax Regulations and §§ 6111 and 6112 of the Internal Revenue Code. This notice also alerts persons involved with these transactions to certain responsibilities that may arise from their involvement with these transactions.

FACTS

In one variation of the transaction, Grantor purchases four options. The value of each one 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 will be a gain in two options (gain options) and a substantially offsetting loss in the other two options (loss options). Grantor creates Trust and funds Trust with the options and a small amount of cash. Grantor gives a short-term unitrust interest in Trust to Beneficiary and retains a noncontingent remainder interest in Trust. The remainder interest is structured to have a value as determined under § 7520 that equals the fair market value of the options. Grantor takes the position that Grantor's remainder interest is a qualified interest under § 2702. Because of the retained remainder interest, Grantor treats Trust as a trust owned by Grantor under subpart E (§ 671 and following), part I, subchapter J, chapter 1 of the Code (a grantor trust). The trust agreement also provides that Grantor will have the power, exercisable in a nonfiduciary capacity, to reacquire Trust corpus by substituting other property of an equivalent value (the substitution power) and that this substitution power will become effective on a specified date in the future. See § 675(4).

After establishing and funding Trust, Grantor sells the remainder interest in Trust to an unrelated person (Buyer) for an amount equal to the fair market value of the remainder interest (which is equal to 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 (prearranged to be equivalent to the fair market value of the options). Buyer gives Grantor an installment obligation (Note), 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 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 § 671.

Grantor claims that, once the substitution power becomes effective, Trust's grantor trust status is restarted (toggled on). 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 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 Grantor's 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.

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. Trust then terminates (by operation of law or Buyer's action), and Trust's 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. Grantor does not treat the termination of Trust as a taxable disposition by Grantor of the assets of 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 would be minimal. If Buyer purchased the remainder interest from Grantor with a Note, Buyer uses the proceeds from the options to pay the Note. If Grantor borrowed to purchase the options, Grantor repays the loan from the Note proceeds.

In another variation of the transaction, the facts are the same as described above except for the following. Grantor contributes to Trust liquid assets such as cash or marketable securities, 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. Before the specified date on which Grantor's substitution power becomes effective, Grantor sells the remainder interest in 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 variation, Grantor claims that the sale terminates (toggles off) Trust's grantor trust status. After the substitution power becomes effective, Grantor substitutes appreciated property for 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), Trust's grantor trust status is restarted (toggled on), and, therefore, the substitution will not cause Grantor to recognize gain.

As described above, Buyer purchases the unitrust interest in Trust from Beneficiary, terminates Trust, and receives Trust's assets on distribution. For tax purposes, Grantor does not treat the termination of Trust as a disposition by Grantor of the appreciated assets in Trust. Buyer claims a basis in the assets of Trust (the appreciated property and cash) equal to the amount paid by Buyer for the 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. One of the purported tax consequences of the second variation 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.

These transactions usually occur within a short period of time during the taxable year (typically within 30 days), and, in each case, Grantor claims that the termination and subsequent reestablishment of grantor trust status, combined with the series of events regarding Trust's assets, result in tax consequences that could not be achieved without both the toggling off and on of grantor trust status. The transactions in this notice, as described above, do not include the situation where a trust's grantor trust

status is terminated, unless there is also a subsequent toggling back to the trust's original status for income tax purposes.

TRANSACTION OF INTEREST

Effective Date

Transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as transactions of interest for purposes of § 1.6011-4(b)(6) and §§ 6111 and 6112 effective August 14, 2007, the date this notice was released to the public. Persons entering into these transactions on or after November 2, 2006, must disclose the transaction as described in § 1.6011-4. Material advisors who make a tax statement on or after November 2, 2006, with respect to transactions entered into on or after November 2, 2006, have disclosure and list maintenance obligations under §§ 6111 and 6112. See § 1.6011-4(h) and §§ 301.6111-3(i) and 301.6112-1(g) of the Procedure and Administration Regulations.

Independent of their classification as transactions of interest, transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the requirements of §§ 6011, 6111, or 6112, or the regulations thereunder. When the IRS and Treasury Department have gathered enough information to make an informed decision as to whether this transaction is a tax avoidance type of transaction, the IRS and Treasury Department may take one or more actions, including removing the transaction from the transactions of interest category in published guidance, designating the transaction as a listed transaction, or providing a new category of reportable transaction.

Participation

Under § 1.6011-4(c)(3)(i)(E), Grantor, Buyer, and Beneficiary are participants in this transaction for each year in which their respective tax returns reflect tax consequences or a tax strategy described in this notice.

Time for Disclosure

See § 1.6011-4(e) and § 301.6111-3(e).

Material Advisor Threshold Amount

The threshold amounts are the same as those for listed transactions. See § 301.6111-3(b)(3)(i)(B).

Penalties

Persons required to disclose these transactions under § 1.6011-4 who fail to do so may be subject to the penalty under § 6707A. Persons required to disclose these transactions under § 6111 who fail to do so may be subject to the penalty under § 6707(a). Persons required to maintain lists of advisees under § 6112 who fail to do so (or who fail to provide such lists when requested by the Service) may be subject to the penalty under § 6708(a). In addition, the Service may impose other penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under § 6662 or § 6662A.

DRAFTING INFORMATION

The principal author of this notice is Tolsun N. Waddle of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Mr. Waddle at (202) 622-3070 (not a toll-free call).