Stripping in Private:
Planning with Stripped Installment Notes

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[Published in Estate Planning, Vol. 33 No. 4 (Warren, Gorham & Lamont, April 2006)]

By most reports, it all probably started in the seventies when some wealthy investor got tired of clipping coupons one at a time on his U.S. Treasury bonds. He commented to his broker, "Why can't I clip all these coupons at once and sell the whole sheet of them to someone else? I'll hold on to the bond itself and receive the principal when it's due." Since the U.S. government seemed like a safe bet to many, a public market actually developed for the separate coupon and bond portions of the bond, and "stripped" treasuries were born.

The problem, at the time, was that the U.S. Treasury Department (and the IRS) wasn't really ready for separate trading of the two, because of what they saw as potential tax abuse. For instance, for an investor who purchased a bond with coupons attached, what would be the tax results when he sold the coupons and kept the bond, or vice versa? Concomitantly, what would be the tax results to the purchaser of the coupons or the bond when subsequent payments were made? While results to the purchaser of the coupons appeared somewhat clear (an income tax on the receipt of payments over her basis), the results to the bondholder were not clear at all. This was because the bondholder (whether the new or original holder) would not receive any payments until the bond matured.

The Treasury's objections to trading stripped notes and bonds were addressed in 1982 when Congress enacted IRC sections 1232 and 1286 dealing specifically with the tax treatment of stripped securities.[1] Thereafter, the market for stripped securities

blossomed, leading to the introduction by the U.S. Treasury itself in 1985 of a program entitled, Separate Trading of Registered Interest and Principal of Securities (STRIPS), where the separate interest and principal components bought and sold by investors were held by the government in book-entry form for tracking and security purposes.

As could quickly be seen, however, the market values of the respective components of a stripped security would have to be discounted from their face value, since the holder of either would have to wait for payments. Thus the components were each traded on a discounted basis. The bonds which were traded without coupons were tagged "zero coupon bonds" (frequently called "zeroes"). And, since the tax consequences of both had now been codified, the concept became so widely accepted and appeared to offer such balance sheet opportunities to publicly traded companies that numerous such companies, as well as municipalities across the country, began issuing their own zero coupon bonds, which had no separate interest portion at all, just a principal note that paid face value at maturity.

Although novel and somewhat off the beaten path of the usual borrower-lender arrangement, the concept of the stripped obligation is really not so difficult to understand. Once a debt exists and the borrower is legally bound to pay the amount back with interest, the document evidencing that debt can be drafted so that the interest obligation can be separated from the principal obligation (just as where all the interest coupons are separated from a coupon bond). After the two obligations are separated, there is no reason why each of the documents may not be sold, exchanged, or even given away separately.

As noted earlier, the overall tax consequences of the transaction are governed under IRC section 1286, including the allocation of basis under IRC section 1286(b)(3) and (4), as well as Revenue Ruling 91-46[2]. When a debt obligation is stripped of its interest payments, these sources require the basis to be allocated between the interest coupons

and the principal note itself. Thus, if a person has a $100,000 debt obligation that carries interest payments at a certain rate for, let's say, 10 years, and that person was to sell the interest coupons but retain the principal note, the gain on the sale of the interest coupons (which would be ordinary income) would be determined based on the proportion of the basis of the note that was allocated to the interest coupons. This would leave the owner holding the non-interest bearing note with a basis attributed to that note, but with a fair market value which is substantially less than the face value of the note, because the principal would not be payable for a period of time and without interest (i.e., a zero coupon bond). Under IRC section 1286 and IRC section 1272(a)(1), the person holding the principal note would then be required to include in his income a portion of the remaining principal balance over his basis each year as if it was an original issue discount (zero coupon) bond, even though no payments were received.

It must be kept in mind, however, that these sections of the tax code were intended to apply to publicly traded debt obligations. Neither Congress nor the IRS, it seems, contemplated the stripping of a private note, but a literal reading of the sections seems to include all stripped debt obligations. The code sections that apply to private notes, but not to stripping per se, are IRC sections 483 and 1272. Nevertheless, it would be difficult to argue that IRC section 1286 as to allocation of basis would not apply, and IRC section 1272, which clearly applies, requires the discount to be treated the same as an original issue discount bond. Furthermore, IRC section 483 and regulations thereunder lead to the application of IRC section 1272 in such cases.[3] And if they didn't, which tax rules would apply?

Stripping in Private

There should be no legal or tax reason why a privately issued promissory note could not be structured so that the interest payments on the note were separable from the principal payment. Thus, we could create our own stripped note by simply structuring the

transaction in two separate documents.[4] One would be in the form of a note requiring principal payment, and a separate document would call for the interest payments, making specific reference to the principal note. [Sample drafts of such documents as contemplated by the author are included at the end of this article (<u>for discussion purposes only, not for actual use</u>). As can be seen, the forms consider the effects of a possible default on principal payments, a default on interest payments, and an early payment of the note.][5]

<u>Income and Gift Tax Considerations</u>

Of course, there are tax issues to bear in mind in connection with the transfer of either the interest or principal portion of the stripped note. Where the payee transfers the principal portion of the note and retains the interest coupons, this would be a potentially taxable gift, but there would be no immediate income tax consequences to the transferee. The transferor, however, is required to include in his income any accrued interest on the coupon to the date of transfer plus the accrued discount on the bond to such date (as it becomes a zero coupon bond).[6] If the donee of the principal portion of the note is not the maker of the note, then when the donee "receives" the face amount of the note, this will be ordinary income to the donee of the amount in excess of the transferor's allocated basis (which becomes the donee's substituted basis). In fact, the discounted note would then be taxed as an original issue discount bond under IRC sections 483 and 1272, and the donee would be required to include in her income each year a portion of the discount as ordinary income, even though she will not actually receive the principal until the note is paid. In most instances, however, the amount of tax would not be prohibitive, and if the donee herself had no funds to pay the tax, the donor or others could easily make annual tax-free gifts to cover the payment.

If the donee of the principal portion is the maker of the note, and if the transfer is a gift, the amount of the gift would seem to be the present (discounted) value of the principal

and not the face value, even though the maker is relieved of the future payment of the face value,[7] an interesting result. And since the transfer is a gift, the forgiveness of debt would not constitute income to the donee/maker.[8] Further, whether the gift is to the maker or someone else, the gift should be subject to the IRC section 2503(b) gift tax annual exclusion even though payment is not due until some future date, since the donee has a present possessory interest in the note and can sell or exchange it at will. The income and gift tax results are not at all clear, however, if the payee was to keep the principal portion but gift the interest portion to the maker. If this happened simultaneous with or close to the original transaction, transfer of the interest coupon probably would not be a gift, but the loan would likely be treated as a below market loan under IRC section 7872. This is because the payee would be left with the principal note payable in the future with no stated interest. If the transfer happened, say, a few years into the note and after interest payments had been made, the result again is not clear, but most likely, the IRS would treat the transfer as creating a new, below market loan from that point. In either event, the donor would be subject to income tax on the accrued amounts to the date of the gift as described above.

If the payee of the note was to retain the principal portion but gift the interest coupons to someone other than the maker, then this would be a gift of the present value of all the interest payments. In addition, it would generate future taxable income to the original payee of the interest coupon (as the interest payments were made), even though the donee would be the one to receive the interest payments from the maker, because of the so-called "fruit of the tree" doctrine under U.S. income tax law[9]. Furthermore, it is interesting to observe that even though the original payee would be the one paying the income tax on the transferred interest payments despite the fact that he did not actually receive the payments, payment of the income tax by the original payee would not constitute an additional gift to the transferee of the interest coupon.[10] It should also be noted, however, that IRC section 1286(a) seems to relate only to the purchase of interest coupons, and where an outright gift of such coupons is involved, it is unclear what the

value would be for the allocation of basis, although it seems reasonable to assume the donee would have a substituted basis from the donor. The donee's substituted basis presumably would be based on the donor's basis in the original note, adjusted for any recognition of income and subsequently allocated to the respective components on a fair market value computation. Unfortunately, it is also unclear as to what happens to the donor/payee's remaining basis. Certainly it could not be applied against the payments of interest, as these should all be taxable to him as ordinary income. Does it simply disappear?

For instance, say that Donor loaned X $100,000 in return for a promissory note of that amount plus an interest coupon at the rate of 5 percent. It is determined that Donor's basis is $65,000 in the note and $35,000 in the coupon. Donor gifts the coupon to X and retains the note. It seems clear that X would take Donor's basis of $35,000 in the coupon. But does this mean that Donor would be left with a $65,000 basis in the note which would then be treated as a zero coupon bond, and "no" basis in the gifted coupons on which he would be taxed? Such a result would be unlikely, but as noted, it is not clear.

Does IRC Section 2702 Apply?

By its express terms, IRC section 2702 applies to transfers "in trust," where the transferor has retained a non-qualifying interest. Where that section applies, it operates to value the transferred interest (typically a remainder interest) at its full value without reduction for the retained interest. Will this section apply to the private stripped note?

First, it must be pointed out that IRC section 2702 dictates the value of the gift FOR GIFT TAX PURPOSES ONLY. It does not change the actual fair market value of the transfer nor does it modify the basis rules. Thus, it applies a false or inflated value to the gift.

Second, it is not at all clear that IRC section 2702 would apply to a stripped note. The key question would be whether the retained interest coupon (if in fact it is retained) would be treated as a "term interest" under IRC section 2702(c)(3). There is a strong argument that IRC section 2702(c)(3) should not apply. That is, when the principal note is transferred, the transferee receives a fee simple interest in the note. She is free to make subsequent transfers or sell or exchange it (assuming it is drafted as negotiable), as it has a marketable value. As such, it is a possessory interest, unlike a remainder interest after a life estate, which is used as an example of a "term interest" in Treasury Regs. 25.2702-4(a). That regulation states that "a term interest is one of a series of successive (as contrasted with concurrent) interests." - such as one or more life estates in property. Here, the interest coupon is separate and distinct from the principal (as it is in publicly traded stripped bonds), and there is no successive interest. It is, in fact, a concurrent interest which the regulations noted above suggest is not a term interest, and therefore, section 2702 should not apply. There are no rulings or cases on the issue.

Even if IRC section 2702 did apply, however, it would not change the use of the tactic for Medicaid purposes, illustrated below. The discount in the amount transferred should still apply because of fair market value rules, and the primary change in the suggested tax consequences would be the gift tax value for federal gift tax purposes. However, if the transaction is treated as a trust (because IRC section 2702 applies), then it is likely that there would be no income to the transferee on receipt of the principal of the note, as a trust in such a case would be a grantor trust under IRC section 677.

Tax Planning With the Stripped Installment Note (STRIN)

Once the separate note and interest coupon are issued, the maker will be able to sell, exchange, pledge, or gift either or both independently, which leaves the planner with

numerous options limited only by her creativity. Perhaps one of its most attractive options is to create the equivalent of a grantor retained income or annuity arrangement (a GRAT) without being subject to the very restrictive rules of IRC section 2702.

For instance, say that Stewart is the sole owner of a successful S Corporation, valued at $4 million and producing a good cash flow. Stewart sells one third of his shares of the corporation to his son, Stalwart, for $1 million, reflecting only a 25% discount from the appraised value, in return for a promissory note for $1 million containing no provisions for interest payments (i.e., a STRIN) and referencing a related interest coupon. Simultaneously, Stalwart executes a separate interest coupon paying the applicable AFR rate and referencing the note.[11] Sometime after the transaction Stewart gifts the STRIN (i.e., the principal part) to his daughter, Stellar, the present value of the gift being about $640,000, and Stewart retains the interest coupon. As discussed above, as Stewart receives the interest payments on the coupon he will be taxed on the full amount of such receipts. His son, Stalwart, should be able to make the interest payments out of the cash flow from the S Corporation shares, and the deductible interest payments will offset some or all of the income tax on the profits.[12] To the extent there was a gain on the sale of the shares, however, Stewart will be required to recognize the gain on transfer of the note.[13] The advantage to this gain recognition is that Stellar will hold the STRIN with a higher basis, though still not its full face value. The discount from face will render it a zero coupon bond and Stellar will therefore recognize a portion of the discount each year as ordinary income. If Stellar does not have the cash flow to pay the tax, Stewart and his spouse could make annual exclusion gifts to help cover the tax.

Unlike a GRAT, if Stewart dies at any point while the note is outstanding, only the value of the adjusted lifetime taxable gift (together with the present value of the interest coupon) will be included in his estate, rather than the appreciated value of the S corporation shares. Furthermore, a gift of the STRIN within three years of his death would not cause any additional value to be included under IRC section 2035. Another

important difference between the STRIN and the GRAT is the ability to apply the IRC section 2503 annual exclusion to the gift, thus reducing even further the amount that would be includable in the donor's estate. And if the circumstances were that the payee/donor of the note was terminally ill and there was a concern over the question of a retained interest, the note could simply be paid off, precluding any concern over the retained interest argument. This illustrates still another advantage over the GRAT, as the optional prepayment by the maker offers something analogous to a commutation, which is not allowed with a GRAT.[14] Further, it would be difficult for the IRS to argue that such a move was a transfer by the original payee since the payment of the note is totally out of his control. In addition, there would be no comparative application of the generation skipping tax rules as there are to the GRAT. The note could be given to a generation skipping trust or even issued by a generation skipping trust without fear of the ETIP rules. Lastly, a sale of Stalwart's S corporation shares would be taxed to Stalwart and not to Stewart, provided the sale does not occur within two years of the purchase.[15]

What About Section 2036?

IRC section 2036 provides, among other things, that property transferred in trust or otherwise, if not for fair consideration, will be included in the transferor's estate where the transferor has reserved the enjoyment of the property for his life or for a period that does not end before his death. Section 2036 will clearly not apply where the note is paid before the death of the transferor. But supposing a transferor who has gifted the note and retained the interest coupon dies before the note is paid and while he is still receiving interest payments? Will section 2036 apply? The answer is yes, but so what? If a taxable gift was made his estate will be credited with the amount of the tax and the market value of the transferred note will be included in his estate, but the transferee will then get a new cost basis. Thus the application of section 2036 will have little or no effect on the plan.

Stripping for Medicaid Planning Purposes

As to how this arrangement may be applied to Medicaid planning, let us propose the following hypothetical: Steve, an elderly gentleman who may enter a nursing home in the near future, has just over $100,000 worth of countable assets in the form of savings. Steve loans $100,000 to his son, Bernie, in return for a negotiable promissory note bearing interest at the rate of 4.6%[16] with principal due in 10 years. The note is drafted in such a way that the obligation to pay interest is separate from the obligation to pay principal, but each document references the other. On the date of issuance the present value of the right to receive $100,000 principal in 10 years is about $64,000. Thus, if Steve makes a gift at that time of the STRIN to, let's say, Bernie's daughter, Steve would be making a disqualifying transfer of only $64,000, as this would be deemed to be the fair market value of the non-interest bearing note, reducing the Medicaid disqualification period on the $100,000 transfer by one-third.

Meanwhile, Steve would have retained the interest obligation, giving him the right to receive quarterly (or less frequent) interest payments for the balance of the 10 years of the note. The interest coupon representing the right to interest payments would be non-transferable and only subject to acceleration in the event of a default. Accordingly, the remaining stream of interest payments would not be considered a resource for Medicaid eligibility purposes, since they are nothing more than a stream of payments, not unlike an annuity that cannot be accelerated. Although in this particular hypothetical we would structure the interest coupon so that it was not negotiable, there may be other situations where the interest coupon could be drafted as a negotiable instrument, perhaps allowing for other planning ideas.

Another interesting feature of this plan is that if it becomes advisable, Bernie (the maker) can at any time stop the stream of interest payments to Steve (the payee) by simply

paying off the balance of the note held by Bernie's daughter. There would be a small prepayment penalty but the flexibility to stop payments is there.

Can We Strip a Self-Canceling Installment Note?

It should also be possible to structure the STRIN as a self-canceling installment note (SCIN). This, of course, may add additional estate and income tax planning possibilities, particularly where assets other than cash or marketable securities may be involved, but it also adds some interesting and not easily answerable questions.

For instance, if the original payee dies before the note (given as a result of a loan rather than a sale of assets for a purchase money note) is paid, will the payee or the donee of the note have a deductible loss analogous to the IRC section 72(b)(3) loss where the decedent did not recover his basis in an annuity? And if sometime after the note is issued the original payee is diagnosed as being terminally ill, or has a certifiably shorter than normal life expectancy, wouldn't this affect the fair market value of the note (if not yet gifted), as well as the value of the interest coupon? Such circumstances would likely affect the fair market value of both the STRIN and the interest coupon, but that fact may not be helpful because an early death is just what makes the SCIN "profitable" from a tax planning standpoint. Lastly, if the self-canceling STRIN was given in connection with a sale of assets, it may be a bad idea to make a gift of the note as this would trigger a recognition of gain under IRC section 453B. In sum, a non self-canceling note seems to offer the best planning opportunities.

Conclusion

Although there seem to be no cases or revenue rulings on private STRINs, there is no identifiable and supportable reason why they cannot be used. Such obligations, issued as a separate obligation to pay principal and a related obligation to pay interest, offer the planner new and interesting possibilities of planning with the separate components, including creation of a superior substitute for a GRAT with virtually none of the drawbacks.

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[1] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248; Also note that IRC §1232 was repealed in 1984 and replaced by IRC §1272.
[2] Rev. Rul. 1991-2 C.B. 358.
[3] IRC §§483(a) and 1272(a).
[4] In fact, subsection (e) of IRC § 1286 provides a clear definition of a stripped bond/note and a separate interest coupon.
[5] For planning purposes, very careful consideration must be given to whether the components are to be negotiable or non-negotiable or one of each.
[6] IRC § 1286(b)(1).
[7] Treas. Reg. 25.2512-1
[8] IRC § 102(a).
[9] *Lucas v. Earl*, 281 U.S. 111 (1930); *Blair v. Commissioner*, 300 U.S. 5 (1937).
[10] IRS Revenue Ruling 2004-64, 2004 IRB Lexis 309.
[11] IRC §1274.
[12] If the buyer is actively involved in the company, he will be able to deduct the interest as a trade or business expense, otherwise they would be deductible as an investment expense.
[13] IRC § 453B.
[14] Treas. Reg. 25.2702-3(d)(4).
[15] IRC § 453(e)(1) and (2).
[16] The applicable AFR rate for July 2005.