Sale to a Grantor Trust (aka Family Installment Sale)

Selling an asset to a "Grantor" trust is a technique which enables a person to remove future appreciation of an asset from the person's estate on a tax-free basis.

A. Typical Transaction

The Grantor sells assets to an irrevocable trust established by the Grantor. The assets are sold in exchange for a promissory note issued by the trust to the Grantor which provides for periodic payments of interest for a specified period of time (e.g. fifteen years), with a single balloon payment of principal upon the expiration of the specified period.

1. The trust is structured so that the assets in the trust are excluded from the Grantor's estate for federal estate tax purposes, but considered owned by the Grantor for income tax purposes. The transactions between the Grantor and the trust have no income tax consequences, no gain or loss is recognized on the sale to the trust, and the Grantor is not taxed on the interest payments on the note.

2. After the end of the specified term, the balloon payment may be made by transferring a portion of the trust asset originally sold to the trust back to the Grantor.

3. If the asset sold to the trust has not increased in value during the period, no estate tax savings was achieved. However, if during the period the asset has appreciated at a faster rate than the interest rate specified in the note, all such excess appreciation has been removed from the Grantor's estate at no gift or estate tax cost.

B. Benefits of Sale to a Grantor Trust

1. Removes Future Appreciation from Grantor's Estate
Future appreciation on the asset sold to the trust in excess of the interest rate stated on the promissory note is removed from the Grantor's estate.

2. Grantor Retains an Income Stream from Assets Transferred

The Grantor retains an income stream (i.e. interest payments) over the term of the promissory note.

3. Transfer is Not a Taxable Gift
The investment assets are sold to the trust at the current market value of such assets; therefore, no taxable gift is involved from the transfer of such assets.

4. Generation-Skipping Benefits Available
The trust can be designed so that the Grantor's children are the initial beneficiaries and upon the death of a child, the child's beneficial interest passes to grandchildren free of estate and gift tax. Since the

initial transfer of the assets to the trust was not a taxable transfer, the beneficial interest in the assets can be transferred free of estate and gift tax through successive generations without using any of the Grantor's generation-skipping exemption.

5. Grantor Liable for Tax on Income Passing to Family Members
The payment by the Grantor of income taxes generated by the trust effectively results in an additional tax-free transfer to trust beneficiaries to the extent such income exceeds the interest payments made to the Grantor.

C. Tax Consequences

1. Income Taxes

a. No taxable gain is recognized on sale of assets to the grantor trust.

b. All income generated by the trust is taxable to the Grantor.

c. Interest income received by the Grantor from payments on the promissory note is not taxable to the Grantor.

2. Gift Tax

a. No gift tax results from the sale of assets to the grantor trust.

b. If other assets are transferred to the trust which are not part of the sales transaction, a completed gift will have occurred. Often the trust contains withdrawal provisions ("Crummey" rights) to enable contributions to the trust to qualify for the annual gift tax exclusion. Gifts in excess of the annual gift tax exclusion will reduce the Grantor's unified gift and estate tax credit.

3. Estate Tax

a. Upon the death of the Grantor, all assets in the trust will pass to the trust beneficiaries free of estate tax.

b. If the promissory is not paid off prior to the Grantor's death, the value of the promissory note is included in the Grantor's estate.

D. Caveats

1. Loss of Step-Up
Upon the death of the Grantor, the property held in the trust will not receive a step-up in basis, rather the assets will retain the Grantor's basis.

2. Grantor Dies Before Note Paid Off

a. The value of the unpaid balance of the promissory note is included in the Grantor's estate.

b. If the Grantor dies before the note is paid off, the IRS may claim that a gain must be recognized to the extent the balance due on the note exceeds the Grantor's basis in the asset.

E. Selecting Appropriate Assets to Transfer to a Grantor Trust

1. Appreciating Assets
Selling an asset to a grantor trust is very beneficial when a client has an asset that is likely to appreciate substantially within a few years. In such a case the term of the promissory note can be for a relatively short period. Payments on the note can be made in kind (i.e. by returning an interest in the property transferred to the trust back to the Grantor).

2. Typical Assets Appropriate for Sale to a Grantor Trust

a. Real estate that will be developed and sold in the near future.

b. Closely-held company that will be sold in the near future.

c. Closely-held company that is planning to go public in the near future.

3. Example
The Grantor sells an asset to a grantor trust for $1,000,000. The asset typically earns $80,000 annually. The trust transfers to the Grantor a promissory note for $1,000,000 with interest payable annually at 1.85% (i.e. the applicable federal rate) and the principal due in full at the end of nine years. At the end of the nine year period, the trust would return to the Grantor $1,166,500 (i.e. principal plus annual interest).

a. If there are no more than ordinary earnings and no growth in the value of the asset, the Grantor would have the entire asset back plus modest internal income and would have gained approximately $500,000 wealth transfer.

b. If there is extraordinary growth in the value of the asset, the increased value would be transferred to the trust beneficiaries at no gift tax cost. In this example, if the asset sold to the Grantor Trust appreciated at 8%, the wealth transfer would exceed $1,800,000.

F. Planning Tips

1. Avoiding Recharacterization of the Transaction by the IRS
If most of the income earned by the asset transferred is returned to Grantor in the form of interest payments, the IRS may attempt to claim the sale was a transfer with a "retained life estate" and thereby include the value of the asset in the Grantor's estate. Therefore, the trust should have other income producing assets (e.g. at least 10% of the purchase price), the income and/or principal of which can be used to partially satisfy the payments on the promissory notes. Additional trust assets can be obtained from earlier or current gifts by the Grantor to the trust.

2. Self-Canceling Installment Note

If the Grantor's life expectancy is shorter than that specified in the IRS tables, consideration should be given to using a self-canceling installment note (SCIN) rather than a balloon note. A SCIN is an installment note which terminates on the seller's death. Any outstanding obligation which is canceled at the seller's death is not included in the seller's federal gross estate. To avoid a gift when this sale is made, payments under the SCIN must be increased to compensate the seller for the possibility that he or she might die before all of the installments have been paid. IRS tables are used to determine the amount that the note should be increased to compensate the seller for this risk. Caveat --if the Grantor lives the full term, the amount payable to the Grantor under the SCIN, and therefore, the increase in the Grantor's estate, is greater than if a standard promissory note were used.