INSTALLMENT SALE TO A GRANTOR TRUST

in brief

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Northwestern Mutual®

Installment Sale to a Grantor Trust

WHAT IS AN INSTALLMENT SALE TO A GRANTOR TRUST?

- An installment sale to a grantor trust is an estate planning technique that “freezes” the value of the property in a grantor’s estate.
- The grantor sells property to an irrevocable trust for its fair market value at the time of the sale. The trust pays for the property with a promissory note that charges an appropriate rate of interest.
- Normally, the trust makes payments of interest only, and repays the principal and any outstanding interest to the grantor at the end of the note’s term. The trust assets remaining after repayment of the note are held for or distributed to the beneficiaries of the trust.

WHY SELL PROPERTY TO A TRUST?

- **Removal of Appreciating Property from Estate.** The property sold to the trust is removed from the grantor’s estate. Any income and appreciation generated by the property after the sale belongs to the trust. If that growth exceeds the interest paid by the trust, the grantor will have succeeded in removing that value from his estate.
- **Estate Freeze.** By selling property to the trust in exchange for a note, the grantor “freezes” the value of the property in his estate. That is, if the grantor dies while the note is outstanding, only the value of the note (not the property sold or any increases in its value) is included in his estate. If the grantor dies after the note has been repaid, the payments from the trust are included in his estate to the extent they have not been spent or given away.

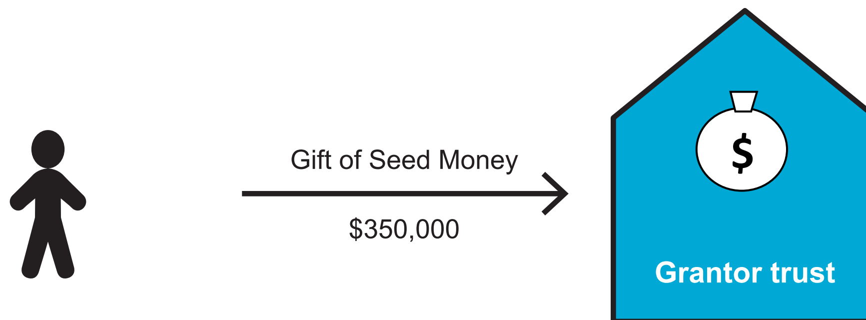
WHAT TYPE OF PROPERTY CAN BE SOLD?

- An installment sale to a grantor trust works particularly well with income-producing assets that are appreciating and that the grantor would like to remove from his estate. Property that will increase dramatically after sale to the trust is ideal – for example, stock in a company that may go public.
- Transferring fractional interests in assets that generate good cash flow (e.g., closely held business or rental real estate) is often desirable. The fractional interest can reduce the value of the transferred asset (valuation discount), and the good cash flow makes it easier for the trust to make the interest payments.

How Does it Work?

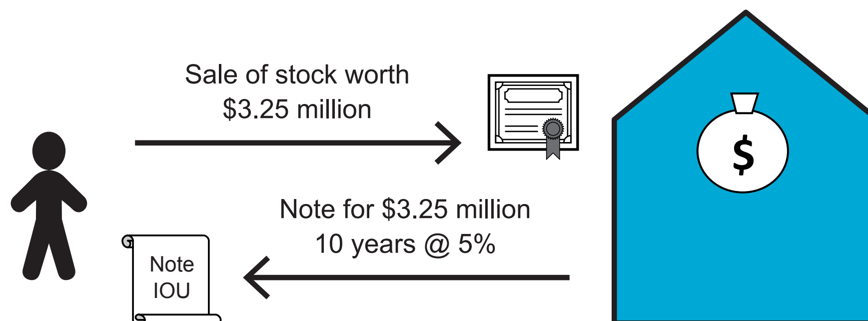
Let's suppose Bill would like to transfer a fractional share of a closely held company to his children. The shares have an undiscounted value of $5 million and generate a net cash flow of 8% per year ($400,000). Assuming a discount of 35%, the fair market value of these shares is $3.25 million.

STEP NO. 1: CREATION OF TRUST AND FUNDING OF "SEED MONEY"



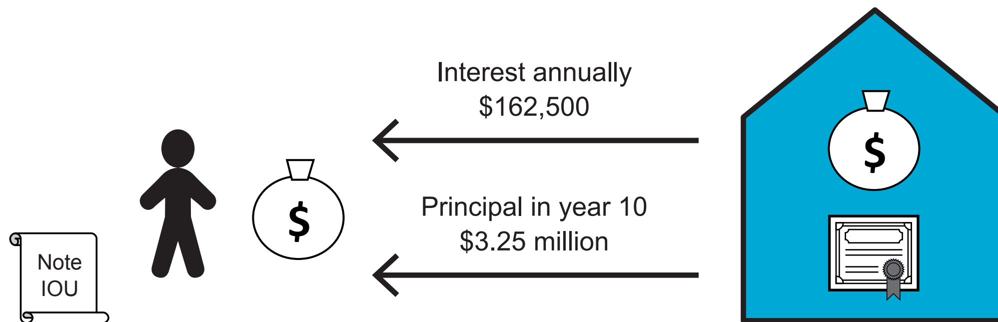
- Bill creates an irrevocable grantor trust. Bill should not be a beneficiary of the trust or retain any powers over the trust property that would cause the trust to be included in his estate for federal estate tax purposes. Generally, Bill should not be the trustee of the trust.
- Bill makes a $350,000 gift of "seed money" to the trust. It is typically recommended that the grantor make a gift to the trust of cash or assets worth at least 10% of the value of the asset that will be sold.

STEP NO. 2: SALE OF ASSETS TO THE IRREVOCABLE TRUST"



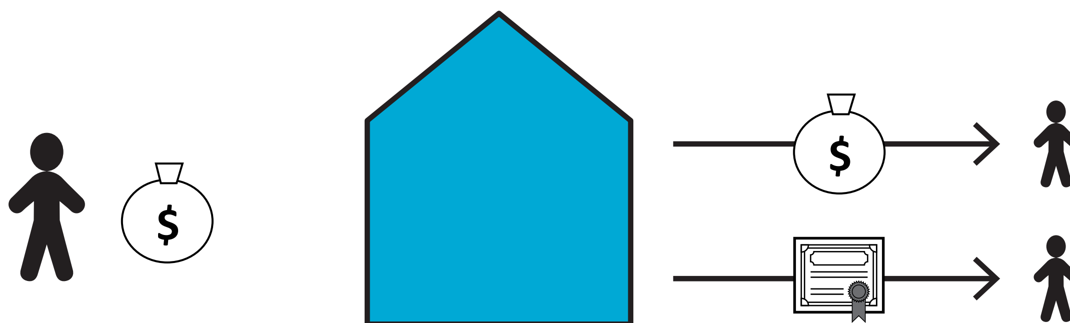
- Bill then sells property to the trust in exchange for a promissory note.
- Normally, the trust pays only interest each year on the note. Principal is paid in a balloon payment at the end of the term.
- In order to avoid a gift, the note must provide for interest at a rate no less than the applicable federal rate (AFR) for the month of the sale.

STEP NO. 3: PAYMENT OF INTEREST AND PRINCIPAL ON THE NOTE



- The trustee uses the income generated by the property to pay interest on the note each year to the grantor, Bill.
- The trust repays the principal at the end of the note term. This may be done using the “seed money,” the stock sold to the trust (or a portion of it if it has appreciated), income from the stock in excess of the interest payments, or other property given to the trust (perhaps using a grantor retained annuity trust or a charitable lead trust).
- The trust retains any property remaining after paying off the note.

STEP NO. 4: DISTRIBUTION OF TRUST PROPERTY



- The property held by the trust is governed by the trust terms and can be invested or distributed as the trust directs.
- Bill has a lot of flexibility in designing the trust. The trust can provide that the stock and other trust assets are distributed outright to his children at a specified time, such as the repayment of the note or Bill’s death. In the alternative, Bill could also provide that the assets stay in trust for the benefit of the children, grandchildren, and future generations.

Paying Life Insurance Premiums

The trust can also own life insurance. To the extent that the trust has income in excess of the interest payments, that income can be used to pay premiums. In our example, Bill’s company generates $400,000 of net cash flow per year. The trust only needs $164,500 to make the interest payment to Bill. The excess cash is available to pay premiums.

Tax Considerations

INCOME TAX

- It is important that the trust be a grantor trust. That is, the grantor is treated as the owner of the trust for income tax purposes. See Internal Revenue Code (I.R.C.) §§ 671-679.
- So long as it is a grantor trust, there are desirable results. See Revenue Ruling 85-13, 1985-1 C.B. 184.
  - The grantor does not recognize income due to the sale of property to the trust – neither on the gain (sale price over basis) nor on interest payments received from the trust.
  - The grantor includes all items of trust income on his individual tax return; the trust pays no income tax.
- The trust receives a carryover basis – the grantor's basis – in the property.
- Upon the grantor's death, the trust can no longer be a grantor trust with respect to the grantor. If the trust has not repaid the note, any gain not recognized at the time of the sale might be recognized at the grantor's death. See I.R.C. § 1001.

GIFT TAX

- Assets transferred by the grantor to the irrevocable trust as "seed money" are gifts.
- The sale of property to a grantor trust in exchange for an installment note is not a gift if the value of the note equals the fair market value of the property. The installment sale is often reported on a timely filed gift tax return to start the statute of limitations period for any valuation challenges.
- The grantor's payment of income tax on the trust's income is not a gift to the trust. See Revenue Ruling 2004-64, 2004-27 I.R.B. 7.

ESTATE TAX

- If the grantor dies before the note is repaid, the value of the note – unpaid principal and interest – is included in his estate.
- If the grantor dies after the note is repaid, interest and principal paid by the trust that has not been spent or given away are included in his estate.
- The trust property is not included in the grantor's estate.

GENERATION SKIPPING TRANSFER TAX

- The trust can be set up to benefit children, grandchildren and future generations.
- For the gift to the trust and the trust distributions to be free from the generation skipping transfer (GST) tax, the grantor must allocate GST tax exemption to his gift of "seed money".
- The grantor's GST tax exemption is not used on the sale portion because the sale is not subject to transfer taxes.

Other Considerations

- **Comparison with GRAT.** A grantor retained annuity trust (“GRAT”) is another estate planning technique that is designed to freeze the value of property in a grantor’s estate. A comparison of the GRAT to an installment sale to a grantor trust is included at the end of this piece.

- **Minimizing the Risk of Estate Inclusion.** On the death of the grantor, the I.R.S. might argue that the sale was not a bona fide sale and, therefore, all of the trust property should be included in the grantor’s estate. In the alternative, the I.R.S. could argue that the grantor had a retained interest in the trust. The following can help minimize the risk of estate inclusion:

  – Make sure the principal amount of the note is equal to the fair market value of the property sold. Obtain an appraisal of the property to be sold to the trust from a qualified appraiser before the sale.

  – Give “seed money” to the trust before the sale. In order for the transaction to be respected as a sale, it is important that it be structured in the same way as an arm’s length transaction. For this reason, it is typically recommended that the trust own some assets prior to the sale.

  – Make sure the interest is sufficient and the loan formalities are followed. The promissory note should be in writing and secured by adequate collateral. The trust must make all payments on time.

  – Do not tie the interest payments to the expected income of the property sold. Doing so increases the chance that the I.R.S. will treat the trust’s payments as a retained income interest by the grantor. See I.R.C. § 2036(a)(1). In addition, having all the earnings from the property paid back to the grantor, as either interest or principal payments, may also look like a retained income interest. For that reason it might be safer for the trust to not prepay the note even if it has additional income.

  – Select a term for the note that the grantor is likely to outlive. This serves two purposes: it preserves the benefit of the “grantor trust” tax rules, and it avoids the potential argument that the trust’s payments on the note are an income interest retained by the grantor.

Comparison:
GRAT vs. Installment Sale to a Grantor Trust

	GRAT	**Installment Sale**
Taxable gift required?	No	No (but 10% - 20% seed gift recommended)
Appropriate for generation skipping transfers?	No	Yes
Tax risk at death? (estate and/or income tax)	Yes (estate tax inclusion of some or all of the trust assets)	Yes (estate inclusion of note; might trigger income tax at death)
Explicit statutory authority for tax treatment?	Yes (see I.R.C. § 2702 and Treasury Regulations)	No (but in line with well-accepted tax principles)
Capital gain recognized on transfer?	No	No
Grantor income taxed on payments from trust?	No	No
Grantor income taxed on trust's income?	Yes	Yes
Distributions to other beneficiaries permitted during trust term?	No	Yes
Ability to correct valuation errors?	Yes	Possibly
Flexibility in structuring annual payments?	Yes (can increase annuity payment up to 20% per year)	Yes (interest only and balloon principal payment is allowed)
Return that the property must generate for technique to "work"	> 120% of federal midterm rate. I.R.C. § 7520.	> 100% of applicable federal (short, mid, or long term) rate

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