Lifetime transfers

Installment sales to grantor trusts, preferred equity interest transactions, GRATs, and other techniques

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Agenda

Installment sales to grantor trusts

Installment sales to grantor trusts

- A freezing technique is a transaction by which an asset’s value is frozen for purposes of determining the transferor’s transfer tax base, which is the total value of his or her taxable gifts during lifetime and his or her taxable estate at death

- Freezing techniques include:
  - A gift
  - A sale
  - An installment sale to a grantor trust

Installment sales to grantor trusts (cont.)

- Freezes the value of the transferred assets at their current fair market value, while the grantor receives interest payments on the note, which are hopefully less than the growth in the value of the transferred assets

- Will not result in any income tax consequences because the sale is disregarded as a sale to oneself, since the grantor is treated as owning the trust assets for income tax purposes

- Allows the trust to make principal payments over an extended period, using the earnings from the transferred assets (there should be no relationship between the earnings and the principal payments to avoid inclusion under I.R.C. § 2036(a)(1))

Installment sales to grantor trusts (cont.)

- A grantor trust is a trust the assets of which are treated for income tax purposes under I.R.C. §§ 671 through 679 as owned by someone other than the trustee, and who, in most cases, is the person who transferred the assets to the trust
- Because the grantor is treated as the owner of the assets in the trust, the grantor reports on the grantor's income tax return the income generated by the trust assets
- The grantor will only be treated as owning the assets the grantor contributed to the trust and assets sold to the trust if he or she is the only grantor
- Another person other than the grantor may be treated as the owner of the assets if he or she relinquished a right to withdraw assets but retained some other right that would have caused him or her to be treated as the owner had he or she been the original transferor
- The transferor may be treated as owning the income of the trust but not the principal, causing the grantor to be taxed on ordinary income but not capital gains

Installment sales to grantor trusts (cont.)

- The transferor of assets to a trust will be treated as the owner of the assets if he or she:
  - Retained the right to enjoy, or to control the enjoyment of, the income or the principal or to revoke the trust, or if someone who is related or subordinate to the transferor has a right to control the enjoyment of the income or principal of the trust assets and the exercise or non-exercise of the right will not affect such person's interest in the trust
  - Retained certain administrative rights or powers with respect to the transferred assets; for example, the right to vote shares of stock, to control the investments, to substitute assets in the trust for assets of equal value, or the right to borrow from the trust
  - Or the income can be used to satisfy the transferor's support obligation or to pay premiums on life insurance on his or her life

Installment sales to grantor trusts (cont.)

- A person may be treated as owning the trust assets for income tax purposes but not for estate tax purposes, in other words, the transfer was either a completed gift or a sale for full and adequate consideration
- It is this dichotomy that allows an individual to be considered the owner of the assets for income tax purposes but not for estate tax purposes
- Otherwise, the installment sale to a grantor trust would not have the desired result of excluding the transferred assets from the transferor's gross estate while avoiding income tax consequences

Installment sales to grantor trusts (cont.)

- How to create grantor trust status:
  - Give someone, including the grantor, a substitution power
    - A power held by the grantor or another person to reacquire the trust assets by substituting assets having the same value, if held in a nonfiduciary capacity
    - The IRS has ruled that such power if held by the grantor will not cause the assets to be included in the grantor's estate if certain conditions are met to insure that the power can not be used to shift benefits
  - Give a nonadverse party the right to add beneficiaries
    - The potential beneficiaries are usually either charitable organizations or spouses of existing younger generation beneficiaries
  - Both of these powers can be relinquished if the grantor decides he or she no longer wants to be taxed on the income from the assets

Installment sales to grantor trusts (cont.)

- The IRS has ruled that the payment of tax on the income by the grantor is not a taxable gift, although it does result in a tax-free transfer of wealth to the beneficiaries
- However, depending upon whether the grantor is or may be reimbursed by the trust for the tax on the trust's income he or she pays, the assets may be included in the grantor's estate

Installment sales to grantor trusts (cont.)

- Tax benefits include:
  - The grantor does not recognize taxable income as a result of the sale to the trust
  - Interest payments will not be taxable to the grantor nor deductible by the trust
  - The sale removes the trust assets out of the grantor's estate if he or she does not retain right or power over the trust assets that would cause inclusion
  - The Generation Skipping Transfer Tax will not apply to the trust assets if the GST exemption has been allocated to any gifts made to the trust (generally to provide so-called seed money) and the installment note received by the grantor is equal to the fair market value of the sold assets and the interest rate on the note is the applicable federal rate
  - Because it is a grantor trust, the trust is a qualified subchapter S trust

Installment sales to grantor trusts (cont.)

- Funding the trust:
  - Many commentators feel that the trust should hold assets having a value equal to at least 10% of the value of the installment note the grantor will receive in exchange for the assets to be sold to the trust by the grantor
    - This avoids an argument that the grantor has retained the enjoyment of the income
  - Some commentators have suggested that the trust beneficiaries could guarantee the installment note, avoiding the necessity of making a taxable gift
    - To avoid the beneficiaries being treated as making a gift, the trust should pay the beneficiaries guaranteeing the note a fee
    - A gift of seed money avoids the uncertainties involved in using guarantees
    - The grantor’s applicable exclusion amount can offset any gift tax

Installment sales to grantor trusts (cont.)

- Non-tax benefits:
  - An installment sale to a grantor trust can be used to deal with a situation where an individual owns a business and wishes to transfer most, if not all, of the business to one or more, but not all of his or her children and still treat all the children equally
  - By using the sale to a grantor trust technique, the individual receives back a note that can then be left to the other children if the individual dies before the note is paid, and the installment payments will increase the grantor’s estate than can be used to equalize the amount eventually going to each of the children

Installment sales to grantor trusts (cont.)

- Income tax consequences:
  - No recognition of income on the sale
  - If the grantor status terminates before the death of the grantor, gain will be recognized
- Gift tax consequences:
  - If the sale of the assets to the trust is considered a sale for full and adequate consideration in money or money's worth, the seller should not be treated as making a gift
  - If interest is charged at the applicable federal rate and the note is equal to the fair market value of the transferred assets, there should be no gift
  - For transactions in January 2022, the AFR is .44% for a short-term note, 1.30% for a mid-term note, and 1.82% for a long-term note (compounded annually)
  - The grantor's payment of tax on the trust's income is not a taxable gift to the beneficiaries

Installment sales to grantor trusts (cont.)

- Estate tax consequences:
  - Unless the transferor has retained rights over the assets in the trust that would cause the assets to be included in his or her estate, the assets in the trust, including the assets sold in exchange for an installment note, should not be included in his or her estate, regardless of whether he or she dies before or after the note has been paid
  - Many commentators advise that before the sale the trust should already hold assets having a value equal to at least 10% of the amount of the installment note to prevent an argument that the grantor has retained an interest in the sold assets that would cause the assets to be included in his or her estate under I.R.C. §2036(a)(1) because there are no other assets to pay off the note

Installment sales to grantor trusts (cont.)

- GST tax consequences:
  - Because the assets initially given to a trust to establish it as a grantor trust will not be included in the grantor’s estate, the estate tax inclusion period (ETIP) rules will not prevent the grantor from immediately allocating his or her GST exemption to the gift
    - The GST exemption can not be allocated until the transferred assets are no longer included in the transferor’s estate or until the grantor’s death
  - Additionally, the subsequent installment sale of assets to the trust will not be a generation-skipping transfer if it is for full and adequate consideration in money or money’s worth

Installment sales to grantor trusts (cont.)

- Termination of grantor trust status:
  - Before death, taxable gain will be recognized by the grantor equal the unrealized appreciation in the unpaid principal
  - After death, it is currently unclear whether there will be taxable gain
  - The basis of the assets gifted and transferred to the trust will be the same basis the transferor had, plus any gift and GST tax attributed to the unrealized appreciation in the assets

Installment sales to grantor trusts (cont.)

- Conclusion:
  - One of the disadvantages of the installment sale to a grantor trust technique is the uncertainly of the tax consequences
    - The IRS had challenged the technique in two cases, the *Karmazin* Case and the *Woelbing* Case
    - Nevertheless, the technique may be a very effective way to transfer assets to younger family members at their current value, as opposed to their presumably appreciated date of death value
  - A disadvantage to the beneficiaries is they will have a carryover basis in the assets when they receive them
  - The formalities should be followed to the letter, including a properly drafted trust agreement, installment note, and any other documents required under state law to transfer ownership of the assets to the trust and support the grantor's status as a bona fide creditor of the trust

Private equity interests

Private equity interests

- In a preferred equity interest transaction, the older family member will receive pursuant to the creation or recapitalization of a partnership or corporation a preferred interest in the entity that will not increase in value, even though the entity's assets, including intangible assets, do increase in value
- Subordinate equity interests, which will increase in value if the entity increases in value, are held by or transferred to younger family members
- The holder of the preferred interest will be entitled to receive a preferred distribution on an annual basis
- Because of the double taxation that would occur in an C corporation and the requirement that an S corporation have only one class of stock, preferred equity interest transactions will involve partnerships and limited liability companies

Private equity interests (cont.)

- Because I.R.C. § 2701 ignores the value of certain rights that the holder of the preferred interest retains, the value of the subordinate interests that are transferred to younger family members will be increased for gift tax purposes, unless the holder of the preferred interest has a qualified payment right, essentially equivalent to dividend paying cumulative stock

- If the dividends are not actually paid, the value of the retained interest will be increased by the unpaid dividends, compounded using the same interest rate used to value the retained preferred interest, when the retained interest is transferred during lifetime or at death

Private equity interests (cont.)

- Preferred equity interests may be beneficial in two situations:
  - When a new entity is formed and the value is rather low and the holder of the preferred equity interest does not have a qualified payment right, but because the value of the entity is low, the increase in the value of the interests transferred to the younger family members is minimal
    - The gift tax will be minimal and any increase in the value of the business will be out of the transferor's estate
  - When the value of the business increases at a rate that exceeds the discount rate used in determining the value of the qualified payment right or guaranteed payment right retained by the older family member
- The valuation rules under I.R.C. § 2701 can be avoided by having only one class of equity interest, although voting and nonvoting rights do not create a separate class of equity interest

Grantor Retained Annuity Trust (GRAT)

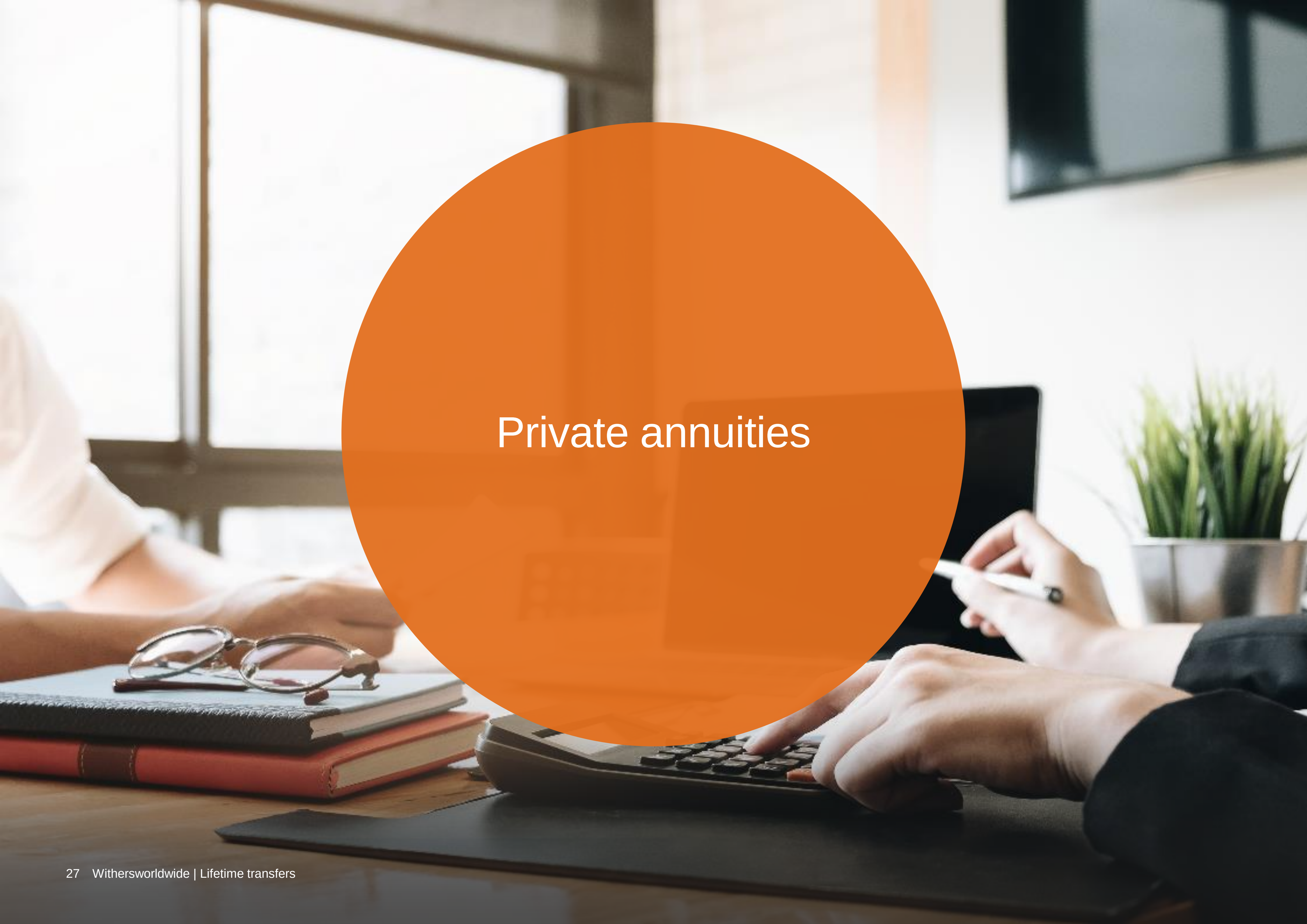
Grantor Retained Annuity Trust (GRAT)

- In a GRAT, an older family member transfers an asset to a trust and retains the right to receive a fixed dollar amount for a period of time, after which the transferor’s interest in the trust terminates and either the asset is distributed to the beneficiaries, usually younger family members, or the trust continues on for some period
  - The gift occurs at the time the trust is created and the termination of the grantor’s annuity interest is not a transfer for gift tax purposes
  - The value of the remainder interest is determined pursuant to the 7520 rate, which for January 2022 is 1.6%
- Because the value of the transferred asset is frozen for transfer tax purposes, if the value of the asset increases at a rate greater than the rate used to value the remainder interest at the time of the initial transfer that passes at the termination of the grantor’s annuity interest, there is a transfer tax-free transfer

Self Cancelling Installment Notes (SCINS)

Self Cancelling Installment Notes (SCINS)

- In a SCIN, the principal amount of the note outstanding at the time of the grantor's death is extinguished
- Because this feature will depress the value of the note, either the principal amount or the interest rate, or both, may have to be increased in order to avoid a taxable gift upon the date of the initial transfer
- If the grantor is in poor health, the SCIN may save estate tax because the note will not be included in the grantor's estate
- The IRS has taken the position that the value of the note should take into account the grantor's medical history at the time of the initial transfer.
- There will be a taxable gift to the extent the value of the note is less than the value of the transferred asset



Private annuities

Private annuities

- In certain cases, the transfer of property to a grantor trust in exchange for a private annuity may result in a significant reduction in the size of the annuitant's gross estate, with no increase in the annuitant's taxable gifts

- A private annuity usually refers to an annuity (a payment in cash of a sum certain at least annually) for the lifetime of the annuitant by a purchaser of the property who does not otherwise issue annuities

Private annuities (cont.)

- The principal estate tax savings in connection with a private annuity is the immediate exclusion of the value of the transferred property from the transferor's transfer tax base, subject to an increase in adjusted taxable gifts if the present value of the annuity is less than the fair market value of the transferred property
- Proposed regulations require the recognition of income on any unrealized appreciation in the assets transferred in exchange for the private annuity

Private annuities (cont.)

- For purposes of determining the present value of the annuity, the valuation tables issued under the Internal Revenue Code are used
- Consequently, the risk element is not reflected in the determination of the annuity, unless the annuitant is terminally ill
  - The actuarial table may not be used in that case
  - An individual who is known to have an incurable illness or other deteriorating physical condition is terminally ill if there is at least a 50% probability that the individual will die within one year
  - However, if the individual survives for 18 months, the individual will be presumed to not have been terminally ill unless the contrary is established by clear and convincing evidence

Financed net gifts

Financed net gifts

- An older family member makes a net gift to a trust for the benefit of a younger family member and lends the trust the money to pay the gift tax
- Under a net gift, the donee assumes the obligation to pay the tax on the gift
- As a result of the assumption of this obligation, the amount of the gift is reduced by the amount of gift tax the donee has to pay
- The concept is described in more detail in the outline, as are the advantages and disadvantages

Potential legislative changes that would affect sales to grantor trusts and GRATs

Potential legislative changes that would affect sales to Grantor Trusts and GRATs

- The Build Back Better Act would have eliminated the tax advantages in using sales to grantor trusts and GRATs by:
  - By including in the value of the grantor trust portion of a trust in the grantor's gross estate and treating distributions from such portion during the grantor's lifetime as taxable gifts
  - Treating sales between the grantor and a grantor trust as taxable events
- These proposals could resurface in subsequent legislation

Biography + Details

Lou is of counsel with the Withers private client and tax team.

His principal concentration is in the areas of taxation, estate and business succession planning, and employee benefits. Lou was on the faculty of the University of Miami School of Law Graduate Program in Estate Planning from 2004 to 2007 and on the faculty of the University of San Diego School of Law in 2009. He was an adjunct professor of law at the University of Richmond Law School from 1978 until 2006.

He is a past Chair of the American College of Tax Counsel; a Past President of the American College of Trust and Estate Counsel; a Charter Fellow of the American College of Employee Benefits Counsel; an Academician and a former Vice President of the International Academy of Trust and Estate Law; a former Vice-chair of the ABA Section of Taxation; and a past Chair of the ABA Section of Real Property, Trust and Estate Law.

Lou frequently serves as an expert witness in matters related to estate, tax, and business planning and trust administration, including malpractice matters on behalf of defendant attorneys.

He has been consistently appeared in The Best Lawyers in America®, *Best Lawyers* in San Diego, Martindale-Hubbell® AV Preeminent® Peer Review Rating™, *Who's Who in American Law*, Top 50 San Diego *Super Lawyers* and Top Attorneys in Business Services in the *Corporate Counsel Edition of Super Lawyers*. He is also the recent lifetime achievement honoree of Bloomberg's Leonard L. Silverstein Award for Distinguished Service in Tax for his contributions to estate planning during his career and was named to the Estate Planning Hall of Fame by the National Association of Estate Planners and Councils.

Education

University of Maryland, B.A. and M.A.
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