The WEALTH DESIGN Center, LLC

Sales to Grantor Trusts -
A Dynastic Estate Planning Tool

A fundamental form of trust used in estate planning is the irrevocable grantor trust. A grantor trust is a trust which, because of certain characteristics, is considered to be the property of the grantor for income tax purposes. Once a person establishes a grantor trust, it can become a tool for organizing the distribution of wealth to many successive generations. From a tax perspective, the trust can receive gifts, which can be free of gift tax today, assuming total gifts haven't exceeded $5,000,000 ($10,000,000 for a married couple).[1]

The Grantor Retained Annuity Trust (GRAT) is another technique based on the grantor trust. GRATs, however, are not structured initially for generations beyond children, because the generation skipping transfer tax exemption cannot be allocated to the gift until the conclusion of the grantor's annuity period. What then, can a person do if she wants income from assets, wishes to use those assets to fund a grantor trust, and intends to benefit not only children, but many generations to come? A technique to consider for that set of circumstances is an installment sale between a grantor (the seller) and her irrevocable grantor trust (the purchaser).

Just a reminder: the appeal of a properly-structured irrevocable grantor trust in estate planning arises from the fact that the trust removes the assets from the taxable estate; for INCOME tax purposes, however, the assets are considered to be owned by the grantor. Any income earned by the trust is taxed to the grantor, just as it was prior to the transfer. Because the grantor is obligated to pay the income tax on any trust income, she can "sell" assets to the grantor trust without recognizing income tax on the "sale."[2] This can be extremely advantageous in the estate planning context for two reasons:

1. **Grantor uses dollars still subject to estate tax for the benefit of the trust outside the estate.** A trustee of a *non-grantor* trust is obligated to pay trust income tax out of trust earnings. If a grantor of a non-grantor trust paid the trust's income tax liability, that grantor would be seen as having made a taxable gift to the trust.

   In contrast, the *grantor* of a *grantor* trust—not the trustee—is **obligated** under the grantor trust rules to pay the tax on trust income. Doing so uses assets still within the grantor's estate to pay the obligatory income tax. This preserves trust assets within the trust for the trust beneficiaries. By virtue of the grantor trust rules, the grantor, in a sense, makes a "gift" to the trust—but solely because of the rules—the payment is not considered a gift.[3] Remember, the grantor is paying income tax on trust assets because the law requires her to pay it, and because of this requirement, the payment is not a taxable gift.

2. **Growth is preserved in the trust outside the estate.** Proper use of grantor trust status thus allows greater accumulation in the trust and preservation of wealth to future generations.

Put a different way, each dollar the grantor retains in her estate is reduced at death by the estate tax, which at its highest marginal bracket in 2011 (without surtax) is 35%.[4] Therefore, any dollars the grantor can legitimately use to pay the income taxes on trust assets during her lifetime are a boon to the trust beneficiaries and make good use of dollars which otherwise would be lost to the estate tax.

SELLING ASSETS TO A GRANTOR TRUST

Sometimes people avoid engaging in an estate planning discussion because they believe the techniques are confusing, complicated and laden with "lawyer-speak." Many techniques ARE confusing, complicated and laden with "lawyer-speak," but a sale to a grantor trust doesn't happen to be one of them.

The installment sale is something most individuals have dealt with many times, from purchasing a car to buying a major appliance over time. An installment sale allows the purchaser to use the asset while making a series of payments to the seller. When the seller and the purchaser are different people, the seller will pay income tax on any gain she recognizes, and that recognition of gain is spread over the term of the sale, along with the tax on the interest portion of the installment payment.

For example, let's assume Anne has owned a business for the last ten years; the business has consistently produced a 20 percent net after tax profit for her. Anne's cost basis in the business is $1,000,000. The value of the business today is $11,000,000. Anne decides to sell her income-producing business to Betty (who is not related to Anne) and allows Betty five years to pay principal and interest. Betty will make a down payment of $1,000,000. Assuming the negotiated interest rate is 5%, Betty will make annual payments of $2,310,000 amortizing the $10,000,000 principal. Anne realizes a 90.9% profit, so 90.9% of each principal payment is taxable to Anne as a capital gain. The interest Anne receives is taxable as ordinary income.

Year	Principal Payment	Interest Payment	Combined Payment	Earnings Required Assume 35% Tax Bracket
1	$2,810,000	$500,000	$3,310,000	$4,823,000
2	$1,900,000	$410,000	$2,310,000	$3,333,000
3	$1,995,000	$315,000	$2,310,000	$3,384,000
4	$2,095,000	$215,000	$2,310,000	$3,438,000
5	$2,200,000	$110,000	$2,310,000	$3,495,000
Total	$11,000,000	$1,550,000	$12,550,000	$18,473,000

As a result, Anne would pay capital gains tax on $10,000,000. Using a 20% capital gains rate, that amounts to $2,000,000 in tax. Additionally, a 35% ordinary income tax rate means she would also pay $542,500 in tax, for a total tax bill of $2,542,500. The "earnings required" numbers above assume interest is income tax-deductible to the purchaser, Betty.

INSTALLMENT SALES AND ESTATE PLANNING

In reviewing how the installment sale transaction works for unrelated parties, the stage is set to demonstrate how the installment sale technique can be used in the estate planning context. We now will assume Anne, who has made no other taxable lifetime gifts, created an irrevocable grantor trust (IGT) for the benefit of her children and future generations. Anne makes a gift to her trust of some of her business shares which would be valued at $1,000,000. Anne will pay no gift tax because she can allocate $1.0 million of her $5 million gift tax exemption to the gift. Anne and the trustee of her irrevocable grantor trust enter into an installment sale agreement, and the trustee gives Anne a promissory note outlining the terms of the agreement for the remaining value of the business.

Because of the estate planning element, Anne is willing to forego annual payments of principal, and the promissory note terms indicate that the trust will pay Anne interest at 3% for eight years, paying off the principal in a balloon payment at the beginning of the ninth year. Note: the sale can be structured with payments of interest and principal, just as it can be structured interest only with a balloon principal payment. Further, the interest should be equal to or greater than the time period's applicable federal rate to avoid the negative consequences of a below-market-rate loan. For our example, we'll assume that 3% exceeds the rate required for a mid-term loan (a loan of nine years).

The trust needs to produce income to make interest payments and accrue sufficient funds for principal repayment, so the subject of the sale should produce income. In this example, the business produces a 20 percent return, which is sufficient to produce the $330,000 for interest payments and accrue the funds for principal repayment.

From an income tax perspective, Anne is able to sell her business without recognizing the gain because of the grantor trust rules governing her trust, which cause the trust to be ignored for income tax treatment. For the same reason, she does not recognize the interest payments in income. Both the gain and interest payments would have been subject to tax had she sold the business to Betty. By selling her business to her grantor trust, Anne saved several million dollars in income tax.

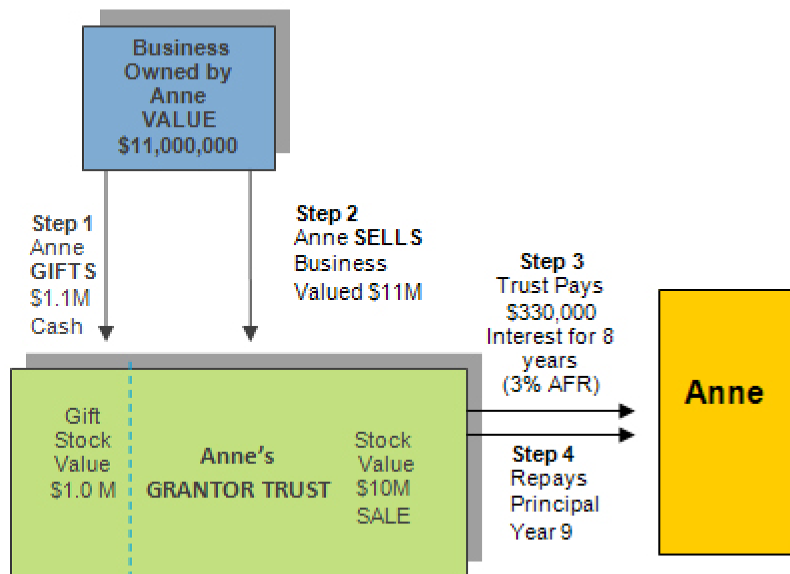
The flip side, however, is that the assets of the trust are still treated as belonging to Anne. She will continue to pay tax on her profits as she did prior to the sale. This technique moves assets out of the taxable estate in the form of income tax, thus preserving growth in the trust for future generations.

A further benefit to the installment sale is that generation-skipping transfer tax (GSTT) exemption may be allocated to the initial gift, and the sale involves an exchange in money or money's worth. GSTT exemption is used on gifts, not sales. In the installment sale to a grantor trust, there are typically no additional gifts to which GSTT exemption would need to be allocated. Contrast the sale technique to a grantor retained annuity trust, which prohibits allocation of the GSTT exemption until the conclusion of the annuity term. If, for example, a GRAT pays an annuity to the grantor for ten years, GSTT exemption allocation must wait until the end of that period. The assets in the trust may have grown significantly from the first year causing significant use of the GSTT exemption. As a result, the GSTT exemption may be exhausted or exceeded, resulting in the need to pay out-of-pocket GST tax. An important advantage to the sale technique when grandchildren are in the picture, the GSTT exemption can be allocated to the initial gift with no GSTT exemption required thereafter because the **sale is not a gift.**

CONCLUSION

Consider using an installment sale to an irrevocable grantor trust, and use the excess income to pay life insurance premiums to create additional liquidity. The installment sale can be a most helpful tool when there's a need for income to the grantor, the primary purpose of the sale is to move the business to the next generation, and generations beyond children need to be considered.

INSTALLMENT SALE



[1]IRC§ 2505 (a) (1).
[2]Rev. Rul. 85-13.
[3]IRC § 671.
[4]IRC § 2001. As of this writing, there is no estate tax in 2010.