Sale to Grantor Trust

Essentials 2018

Grantor Trusts, revocable or irrevocable, are trusts in which income is attributed to the grantor instead of the trust. Irrevocable grantor trusts are often used when transferring highly appreciating or income producing assets to keep them out of the estate. For the purposes of this planning technique, the kind of irrevocable trust used is known as an "Intentionally Defective Irrevocable Trust (IDIT)." The "defect" in the trust is an intentional provision that causes income to flow back to the trust's grantor – qualifying the trust for grantor income tax treatment while also removing the assets for estate tax purposes. By paying the taxes on the trust income, the grantor allows the trust assets to grow without being reduced by taxes.

How a Sale to a Grantor Trust Works

1. The trust is drafted so that the grantor is considered the trust owner for income tax purposes, but not for gift and estate tax purposes.
2. The grantor will make a gift of cash and/or assets to the trust. (The IDIT must be "seeded" or otherwise made a viable borrower – adequate "seeding" may be between 10% and 20% of the value of the value of property sold.) This is done using annual gift exclusions or the client's gift tax exemption.
3. After the gift, the client sells assets to the trust in exchange for an installment note payable over a specified period of time. The note must bear an adequate rate of interest based on the note's duration – based on the applicable federal rate (short-term, mid-term, or long-term).
4. The assets sold to the IDIT will hopefully provide sufficient income to cover the debt service. Any excess income can be added to trust principal or expended for other uses (i.e. paying premiums).
5. The assets remaining in the trust can remain in the trust or go to the beneficiary after the note is repaid.

Sales to Grantor Trusts are Effective Estate Planning Techniques

- No capital gain is recognized by the seller upon transfer of the assets.
- The IDIT assume the seller's basis in the property sold.
- The income or gain generated inside the IDIT is taxable to the client (lender) even though it is not distributed to the client (lender).
- The interest received on the note is neither taxable nor deductible.

Considerations

- A sale to the grantor trust is also effective in planning to terminate premium financing of life insurance; private financing of life insurance, and economic benefit split dollar arrangements.
- There are gift tax concerns if the IDIT must be seeded by gifting funds. However, these can be made subject to the grantor's annual exclusions if property structured or the client's gift tax exemption.
- The sale could be structured to cancel any outstanding balance of the note at the seller's death by using a Self-Canceling Installment Note (SCIN). The adequate rate of interest or face amount must be adjusted to include a premium reflecting the risk that the seller dies before receiving full payment.

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- If the seller does not survive the term of the IDIT, the remaining balance on the note is included in his/her estate for Estate Tax purposes.
- There are no gift tax concerns regarding the sale as long as the note bears an adequate rate of interest.
- The IDIT may provide for distributions to the grantor to pay the taxes.
- By paying the taxes on the trust's income the grantor allows the trust's assets to grow. Payment of the taxes is not considered a gift to the trust.

Essentially

A sale to a grantor trust is a planning technique that may allow you to achieve significant tax benefits while funding an irrevocable trust during lifetime. Essentially it allows you to transfer assets outside your taxable estate at a discounted value and then use the trust income to fund a needed life insurance policy.

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