

Sale to a Grantor Trust

Estate Planning Strategies

A grantor can create an irrevocable trust, the assets of which he or she is considered to own for federal income tax purposes, but not for federal gift and estate tax purposes. The grantor can then sell property to the trust in exchange for the trust's interest bearing promissory note, without federal income tax consequences. The sale can produce federal estate and gift tax savings if the trust property appreciates in excess of its value on the date of the sale plus the interest due on the note.

Grantor Trust

A grantor trust is a trust that is not a separate taxpayer for federal income tax purposes. Instead, the grantor of the trust is deemed to own the trust assets and therefore, all income, deductions and credits attributable to the trust property will be reported by the grantor on his or her personal federal income tax return. Non-grantor trusts are separate taxpayers.

Grantor trust status can be established in many ways. For example, if the grantor, the grantor's spouse or other persons have certain interests or powers with respect to the trust, such as: (i) naming the grantor's spouse as a beneficiary eligible to receive distributions; (ii) naming the grantor's spouse as trustee with the power to "sprinkle" income and principal among trust beneficiaries; (iii) authorizing the

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trustee to lend to the grantor or grantor's spouse for less than adequate security or interest; and (iv) giving the grantor or another person the power to reacquire trust property by substituting other property of equivalent value.

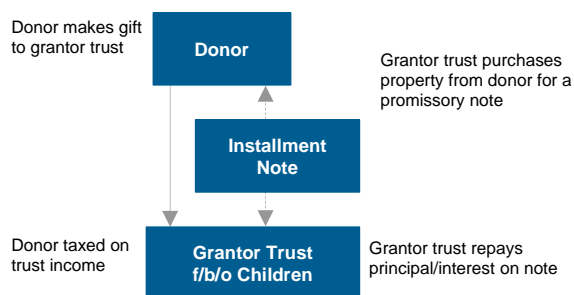
The estate planning benefit of grantor trust status is that the grantor is required to pay taxes on the trust's income, so that such payment is not a taxable gift. The tax payment allows the trust to grow income tax free thereby passing additional wealth to the beneficiaries free of federal gift tax.

The Sale

Grantor trust status also allows the grantor to transact with the grantor trust without federal income tax consequences. The grantor can sell assets to the trust in exchange for the trust's interest-bearing promissory note of equal value so that there is no gift element. The note must bear interest, at a minimum, equal to the applicable federal rates published monthly by the IRS. Any intra-family loan with interest below such rate would result in a gift.

The promissory note may provide for level payments of principal and interest, be self-amortizing or bear interest only with a balloon payment of principal at maturity. The note can authorize the prepayment of principal and it can be secured (even by the assets sold to the trust). The grantor is not subject to federal income tax on the interest payments on the note because of the trust's grantor trust status.

Overview



Federal Gift Tax

The trust should be funded prior to the sale so that the trust has sufficient assets to support the note. Otherwise, there is a risk that the IRS may not respect the transaction or argue that the grantor retained an interest in the trust, thereby causing federal estate tax inclusion. Most commentators suggest that the "seed gift" be at least 10% of the principal amount of the promissory note. The transfer of property to the trust can be made utilizing the federal gift tax annual exclusion (if the trust is structured properly), and the federal gift tax exemption amount, currently equal to \$12.06 million in 2022.

Federal Estate Tax

If the seller dies before the note is repaid, the value of the promissory note is included in the seller's gross estate for federal estate tax purposes. The value of the note for federal estate tax purposes may be its unpaid face amount, or less, depending upon the interest rate environment and likelihood of repayment. If structured properly, the trust property will not be included in the seller's gross estate for federal estate tax purposes.

Installment Method

There are no federal income tax consequences to the sale between the grantor and the grantor trust. Thus, the installment method of spreading out taxable gain is not applicable.

Advantages

As stated earlier, the grantor's payment of income taxes on behalf of the trust generates federal estate and gift tax savings as property is indirectly transferred to the trust without the payment of federal gift tax or use of gift tax exemption.

Additional savings will be generated if the trust property has an annual return in excess of the interest rate on the note over its term. The trust beneficiaries receive the return on the trust property in excess of the interest rate on the note. The IRS's prescribed interest rates have been at historic lows and therefore, a low hurdle for transfer tax savings. A sale to a grantor trust also can be an effective planning tool for the generation-skipping transfer (GST) tax, an additional layer of tax imposed on transfers to grandchildren or others treated as being two or more generations younger than the transferor. Each taxpayer has a GST exemption amount (\$12.06 million in 2022) which can be used to protect transfers from the GST tax. The GST exemption amount can be allocated to the trust immediately on the funding of the trust allowing all

trust property, including any future growth, to be protected from the GST tax (assuming the donor has sufficient GST exemption available at the time of the transfer).

Disadvantages

As noted above, most commentators agree that the trust must have sufficient assets other than the property purchased from the grantor to support the trust's indebtedness. Otherwise, the IRS may argue that the grantor retained an interest in the trust. If the grantor is deemed to have retained an interest in the trust, it can be included in his or her gross estate for federal estate tax purposes on his or her death.

If appreciated property was sold to the trust and the grantor dies while the note is outstanding, the grantor's death may trigger gain recognition for federal income tax purposes (although some commentators argue that death is not a recognition event). Also, the IRS may challenge the valuation of any non-marketable assets transferred to the trust, creating potential federal gift tax exposure.

Important Disclosure

Morgan Stanley Smith Barney LLC does not accept appointments nor will it act as a trustee but it will provide access to trust services through an appropriate third-party corporate trustee.

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