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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Grantor Trust Transactions - SCINs, Installment Sales, and Private Annuities: Is the IRS Circling the Wagons?

MARKET TREND: Continual IRS interest in installment sales and similar transactions with grantor trusts requires clients and advisors to proceed with care.

SYNOPSIS: Grantor trust sale transactions, like installment sales, self-canceling installment notes ("SCINS") and private annuities, have been consistently used as legacy management and business succession planning tools. In recent internal guidance and estate tax audits, however, the IRS has rejected some generally accepted approaches to conducting these transactions, based on the valuation of the notes, the grantor's expectation that the obligations would be repaid, and the trust's ability to fund the repayment. The Administration's recent budget proposals also have targeted the taxation of sale transactions with grantor trusts.

TAKE AWAYS: With proper planning, grantor trust sale transactions can help preserve illiquid assets, like family businesses, for the next generation, who may otherwise be forced to sell the asset on a "fire-sale" basis to cover taxes and estate administration expenses. Heightened regulatory interest in these transactions, however, has emphasized the importance of having a team of skilled advisors who can collaborate to properly document, implement, and maintain this multi-faceted planning. Key components include ensuring the value of the note or annuity obligation matches the fair market value of the assets sold, evidencing that the trust has sufficient ability to re-pay its obligations, complying with all payment terms, and enforcing the grantor's rights in the event of non-compliance. Incorporating life insurance into the plan can offer additional liquidity upon the grantor's death, which can ease concerns if federal tax payments unexpectedly arise.

PRIOR REPORTS: 14-13; 13-46, 13-16, 12-22.

Sale transactions between a grantor and a grantor trust, such as installment sales, SCINs, and private annuities, have long been used in legacy management and business succession planning to transfer family or business assets to the next generation. The purchase of life insurance in the trusts is often a complementary component of the overall legacy plan, with premiums payment supported by the assets sold.

Recently, however, the IRS has shown a greater interest in installment sale and SCIN transactions with grantor trusts, scrutinizing both their estate and gift tax efficacy. While this may create more interest in private annuity transactions for certain clients, all these transactions have similarities that require careful planning, documentation, and administration to help withstand any potential regulatory review. The following summarizes these transactions, recent IRS challenges, and planning considerations in light of these events.

OVERVIEW: GRANTOR TRUST SALE TRANSACTIONS[1]

A client's sale of an illiquid asset, like a family business, to a grantor trust removes the asset and its future appreciation from the client's estate, replacing it with a non-appreciating, fixed payment stream. This type of lifetime planning can avoid "fire-sales" of family businesses and other illiquid assets, helping to preserve them for the next generation. Common grantor trust sale transactions include the following (***see chart for a summary comparison***):

Installment Sales. With an installment sale, the grantor sells assets to a grantor trust in exchange for an installment note for a specified term of years. To avoid making a gift: (1) the note must charge sufficient interest, e.g., at the applicable federal rate ("**AFR**") and (2) the note's value must equal the fair market value ("**FMV**") of the asset sold. Also, the grantor may need to make a "seed" gift to the grantor trust[2] or find other methods (such as personal guarantees[3]) to capitalize the trust so it can meet its note obligations. If the grantor dies during the note term, only the note's value should be includible the grantor's estate. Thus, the term should be less than the grantor's life expectancy ("**LE**").

SCINs. SCINs are installment sales with an automatic cancellation provision that terminates the repayment obligation if the seller dies before the end of the note's term. The self-cancellation feature arguably removes the note's value from the seller's estate for estate tax purposes.[4] To avoid making a gift, the SCIN's FMV must equal the property sold, and the SCIN must include a "risk premium," such as a higher purchase price for the asset, a higher interest rate for the note, or some combination thereof, to account for the possibility of early termination.[5] Because of the note's mortality feature, SCIN valuations often rely on actuarial tables under Internal Revenue Code ("**Code**") §7520 ("**7520 tables**") to determine both the risk premium and overall value.

Private Annuities. In a typical private annuity transaction, the grantor transfers property to a grantor trust in exchange for the trust's obligation to make fixed annuity payments to the grantor for the remainder of his or her life. The annuity obligation terminates upon the grantor's death, so that, arguably, nothing is included in the grantor's estate for estate tax purposes. To avoid making a gift, the actuarial present value of the annuity (based on the grantor's LE under the 7520 tables) should equal the FMV of the property sold. Also, the grantor trust must satisfy the "exhaustion test" -- i.e., the trust must have sufficient funds to make all annuity payments until the annuitant attains age 110[6] -- which can pose an additional funding requirement far more substantial than the "seed" gifts suggested for installment sales and SCINs.

CURRENT AREAS OF CHALLENGE

Despite, or perhaps because of, their popularity, grantor trusts and sales to grantor trusts have come under recent scrutiny. As discussed in *WRMarketplace # 13-05*, a proposal in the President's FY 2016 budget would subject grantor trusts that engaged in sales disregarded for income tax purposes (e.g., sales with the grantor) to transfer tax on the assets acquired in the sale. In addition, recent Tax Court cases and IRS internal guidance indicate renewed IRS interest in installment sale and SCIN transactions (see *Estate of Marion Woelbing v. Commissioner,*[7] *Estate of Donald Woelbing v. Commissioner*,[8] *Estate of Davidson v. Commissioner*,[9] and CCA 201330033, as discussed in *Washington Report No. 14-13*). Notable challenges to these transactions include the following:

- **Bona Fide Debt / Expectation of Repayment / Ability to Pay**. The IRS has focused repeatedly on whether the note represents bona fide debt, as opposed to a transfer of equity to the trust with a retained interest. While there are numerous factors that impact this analysis, the IRS has looked closely at whether there is a real expectation of repayment or intention to enforce the debt[10] including whether the trust has a demonstrable ability to pay the debt (i.e., sufficient assets in addition to those purchased).[11] If the IRS determines the note is not bona fide, it may classify the entire transfer as a gift, which would result in estate tax inclusion of the assets due to the grantor's retained interest (the right to receive note payments).[12]

- **Note Valuation**. The IRS may challenge the note based on insufficiency of the interest rate (i.e., the AFR is not commercially reasonable)[13] or principal, resulting in a taxable gift equal to the difference between the note's re-determined value and the FMV of the property sold.

- **Target on SCINs**. With regard to SCINs, the IRS has cited a SCIN's interest-only payment feature and the grantor's lack of need for the income from the SCIN as evidence there was never an intention to repay or enforce the debt.[14] Further, the IRS has targeted the valuation of SCINs and the risk premiums, claiming that SCINs cannot be valued using the §7520 tables, as they only apply for annuities, interests for life or a term of years, or remainders. Rather, SCINs should be valued based on a "willing-buyer/willing-seller standard,"[15] considering ***the grantor's LE based on his or her medical history as of the date of the SCIN.***

- **Asset Valuation**. Disputes with the IRS over asset valuation and the applicability and size of discounts have become a major focus in the transfer tax arena for gifts or sales of closely-held business interests, real estate, and other hard-to-value assets. Some commentators query whether other issues raised by the IRS are a means to bolster its position that a transferred asset has been undervalued for transfer tax purposes.

PLANNING CONSIDERATIONS

Even with the IRS's heightened sensitivity to these transactions, they may still make sense for clients who understand the risks and work with a team of skilled advisors who can collaborate to properly document, implement, and maintain this multi-faceted planning. If contemplating one of these transactions, clients and their advisors should carefully consider the following:[16]

- **Create a Bona Fide Debt**. For installment sales and SCINs, take steps to ensure the note is respected as debt and not re-characterized as a retained equity interest in the transferred assets. Indicia that the sale is bona fide and for full and adequate consideration include: (i) the trust's ability to pay the debt, (ii) the trust has other assets that can be reached in the event of a default, (iii) there is a reasonable expectation of repayment and an intent to enforce collection, and (iv) if the note is a SCIN, the term of the note is within the seller's LE.

- **Evidence Ability to Repay**. Ensure the trust is sufficiently capitalized with property other than the assets purchased, including satisfying the exhaustion test if a private annuity is used. Options include pre-funding a trust with sufficient assets (but see below for seed gifts made before a sale) or using a pre-existing trust with sufficient assets, although this may require a substantial gift or pre-existing trust assets, particularly if the exhaustion test applies. If these options are not available the client may consider obtaining personal guarantees from creditworthy individual beneficiaries of the trust.[17]

- **Follow Formalities**. The grantor and the trust must follow all formalities, including documenting and recording property transfers, making timely note or annuity payments, assuring proper tax reporting, etc. The grantor should take prompt action to enforce its rights if payments are not timely made.

- **Consider Defined Value Clauses**. Consider incorporating a defined value, "Wandry"-type clause into the trust agreement and sale documents, which provides that the grantor is only selling assets with a value equal to the value of the note or annuity, as finally determined for federal gift tax purposes (note, however, that the IRS did not acquiesce in the *Wandry* decision, as discussed in *Washington Report No. 12-52*)[18]

- **Separate Pre-Sale Trust Funding from Sale**. Separate, in time, "seed" gifts to fund the trust from the sale to the trust (30 days at a minimum, but longer is better). This may help avoid a potential argument to collapse the two transfers into a single gift with a retained life interest, which would bring the assets back into the grantor's estate.

- **Use Another Lender**. For installment sales or SCINs, the grantor's spouse or another grantor trust could make a loan to the purchasing trust to buy assets from the grantor, so that the subsequent note payments are made to a different lender (not the grantor) as a separate transaction.

- **Do Not Tie Payments to Performance**. Note and annuity payments should not be contingent on the investment performance of, or income generated by, the asset sold or the trust overall. Note or annuity obligations should be payable from the entire trust principal.

- **Note Carryover Basis.** As the transaction is disregarded for income tax purposes, the assets sold will have a carryover basis for income tax purposes.

- **Weigh Risks of Backloading**. Delaying payments on SCINs may bolster arguments that there was no expectation that the debt would be fully paid.

- **Understand Uncertainty in SCIN Valuations**. The IRS CCA has created uncertainty about whether the 7520 tables can be used to value SCINs for gift tax purposes, as opposed to a "willing buyer-willing seller" standard.

- **Expect Scrutiny for Early Deaths**. For SCINs and private annuities, which create a "windfall" to the trust beneficiaries if the grantor dies early in the note or annuity term, expect IRS scrutiny if the seller dies unexpectedly, especially if within one year of the transaction and/or the seller had known health issues.

- **Potential for "Overpayment"**. For SCINs and private annuities, if the grantor outlives the note term or his or her LE, then the trust will pay more than FMV for the assets sold, returning growth to the grantor's estate.

INCORPORATING LIFE INSURANCE INTO THE PLAN

Given the current regulatory interest in grantor trust sale transaction, insurable sellers may want to consider the use of life insurance as part of the plan to hedge against the risk of unexpected gift or estate tax liabilities (e.g., inclusion of a non-canceling installment note in a seller's estate if the seller unexpectedly predeceases the note term). In addition, life insurance (either on the grantor or the grantor's spouse) can be used to equalize other heirs of the grantor who may not participate in the sale as part of a partial business succession to only active heirs.

TAKE AWAYS

- With proper planning, grantor trust sale transactions can help preserve illiquid assets, like family businesses, for the next generation, who may otherwise be forced to sell the asset on a "fire-sale" basis to cover taxes and estate administration expenses.

- Heightened regulatory interest in these transactions, however, has emphasized the importance of having a team of skilled advisors who can collaborate to properly document, implement, and maintain this multi-faceted planning.

- Key components include ensuring the value of the note or annuity obligation matches the FMV of the assets sold, evidencing that the trust has sufficient ability to re-pay its obligations, complying with all payment terms, and enforcing the grantor's rights in the event of non-compliance.

- Incorporating life insurance into the plan can offer additional liquidity upon the grantor's death, which can ease concerns if federal tax payments unexpectedly arise.

Grantor Trust Sale Transactions: Installment Sales vs. SCINs vs. Private Annuities

Grantor Trust Transaction	**Installment Sale**	**SCIN**	**Private Annuity**
Typical Payment Term	Set by grantor – will have estate tax consequences if grantor dies during term	Set by grantor, but should not exceed life expectancy (**LE**).	Grantor's lifetime
Purchase Price to Avoid Gift	Note value = asset's fair market value (**FMV**)	Note value = asset's FMV*	Actuarial present value of annuity = asset's FMV
Interest Rate	AFR (as specified for month and term of note)	AFR*	N/A (Annuity payments effectively capitalize interest)
Additional Funding Requirements	Seed gift or guarantees	Seed gift or guarantees *Mortality risk premium: higher principal and/or interest	Must meet exhaustion test (trust is able to pay annuity until grantor is age 110)
Cash Flow to Grantor	Note payments	Note payments	Annuity payments
Income Tax	Disregarded transaction	Disregarded transaction	Disregarded transaction
Gift Tax	None if sufficient principal and interest on note	None if sufficient principal, interest, and risk premium on note	None if annuity's present value equals asset's FMV and trust passes exhaustion test
Estate Tax	Asset and future appreciation removed from estate. Value of note <u>included</u> if grantor dies during term	Asset and future appreciation removed from estate. Value of note <u>excluded</u> if grantor dies during term	Asset and future appreciation removed from estate. Annuity ceases at death so <u>nothing included</u> in estate
When to Consider	For individuals who: • Are in good health and expect to survive note term • Want to maximize limited gift tax exemption (e.g., \$100,000 gift could seed a \$1,000,000 sale) • Have assets with growth potential • Want to take advantage of low AFRs • Want some cash flow or to only transfer asset growth	For individuals who: • Have shortened LEs but at least a 50% chance of living one year • Do not need lifetime cash flow • Want to take advantage of low AFRs Do <u>not</u> use for individuals with terminal illnesses	For individuals who: • Have shortened LEs but at least a 50% chance of living one year • Want cash flow for life • Have an existing, pre-funded grantor trust that could satisfy exhaustion test • Want to avoid valuation uncertainty with SCINs Do <u>not</u> use for individuals with terminal illnesses
Potential Tax Issues	• Note value insufficient (due to interest or principal) • Note is not bona fide debt (no expectation of repayment or intent to enforce, etc.). Re-characterize as a gift with a with a retained interest • Trust lacks sufficient assets to repay note • Assets sold are undervalued	• Note value insufficient (including risk premium) • Note is not bona fide debt (particularly if seller dies early in term) • Note cannot be valued using Code 7520 actuarial tables • Trust lacks sufficient assets to repay note • Assets sold are undervalued	• Estate inclusion due to retained interest (trust is thinly funded, trust income tied to value of annuity payments, formalities not followed, etc.) • Note cannot be valued using Code 7520 actuarial tables • Trust lacks sufficient assets to repay note • Assets sold are undervalued

NOTES

[1] This report assumes that the purchaser in each transaction is a trust treated as a wholly-owned grantor trust for federal income tax purposes with regard to the seller. As these transactions are disregarded for income tax purposes, they should not generate income tax recognition events.
[2] Some practitioners suggest a 10% rule-of-thumb for the seed gift (i.e., gift equals 10% of the value of assets sold).
[3] Note the use of guarantees should involve an assessment of whether the trust should pay a fee for the guarantee and how that fee should be determined. In addition to supporting the bona fide character of the guarantee, a fee may help avoid triggering a possible gift by a trust beneficiary who provides a gratuitous guarantee, even though the gift may occur only if the guarantee is called. See discussion of seed gifts and guarantees in Martin M. Shenkman, "Role of Guarantees and Seed Gifts in Family Installment Sales," Estate Planning Journal (WG&L), Nov. 2010. See also Trombetta v. Commissioner, T.C. Memo. 2013-234 involving a private annuity transaction with a trust, where the court did not recognize the guarantees because the guarantors never paid, and were unlikely to be called on to ever pay, anything on the guarantees and the guaranties only covered the annuity payments but, in this case, the grantor had an implied agreement to retain enjoyment over all trust assets, not just the annuity. Consider, however that this case had numerous "bad facts,", including the grantor's retained enjoyment of all trust assets.
[4] *See*, *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), *acq. in result*, 1981-2 C.B. 1.
[5] See Code § 2512(b); Reg. § 25.2512-8.
[6] *See* Treas. Reg. §§ 1.7520-3(b)(2)(i), 20.7520-3(b)(2)(i) and25.7520-3(b)(2)(i).
[7] T.C. No. 30260-13.
[8] T.C. No. 30261-13.
[9] T.C. No. 013748-13, *filed* June 14, 2013, *answer filed* August 9, 2013.
[10] *See*, *Estate of Costanza v. Commissioner*, 320 F. 3d 595 (6th Cir. 2003), *rev'g,* T.C. Memo 2001-128.
[11] *See Estate of Donald Woelbing v. Commissioner,* T.C. No. 30261-13.
[12] If the IRS re-characterizes an installment sale to a trust as a contribution to the trust with a retained right to receive payments pursuant to the note, the transaction would fall under Code §2702, dealing with the valuation of retained interests for gift tax purposes. Since the retained interest would not represent a qualified annuity interest (as under a GRAT), the installment note would be valued at $0, resulting in a gift of the entire value of the asset sold. The estate tax inclusion also arises under Code § 2036, as a transfer of property by the grantor with a retained interest.
[13] *See Estate of Donald Woelbing v. Commissioner,* T.C. No. 30261-13.
[14] *See Estate of Davidson v. Commissioner*, T.C. No. 013748-13.
[15] *See* Treas. Reg. § 25.2512-8.
[16] See Steve R. Aker's discussion of these issues in *Heckerling Musings 2015 and Current Developments*, February 2015 at http://www.bessemer.com/advisor; "SCINs and Private Annuities: Disappearing Value or Disappearing Strategies?," presented January 13, 2015, and "Planning with SCINs and Private Annuities – Seizing Opportunities While Navigating Complications," presented January 14, 2015, both at the 49th Annual Heckerling Institute of Estate Planning, January 2015.
[17] See discussion at Note 3 regarding issues to consider when using personal guarantees.
[18] See discussion in *Washington Report Nos. 12-34* and *12-52.*

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