Finseca Report
Marketplace

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Grantor Trust Transactions: Time to Revisit SCINs, Installment Sales, and Private Annuities

Market Trend: Rising interest rates, degrading asset valuations, and future legislative uncertainty coupled with high wealth transfer tax exemptions mean it's a great time to revisit installment sales and similar transactions using grantor trusts.

Synopsis: Grantor trust transactions, like installment sales, self-canceling installment notes ("SCINS") and private annuities, have been used as legacy management and business succession planning tools. Now may be the opportune time for clients and advisors to use these transactions due to the current economic and legacy planning environments. Advisors should take care when implementing these transactions since the IRS has targeted these transactions both legislatively and in court. Sale transactions with grantor trusts are still viable and there is a window of opportunity to capitalize on the leverage these transactions provide.

Take Aways: Historically low IRS prescribed interest rates (which are trending upward), depressed asset values, legislative uncertainty, and historically high wealth transfer tax exemptions make it a strategic time for families to consider grantor trust sale transactions to maximize wealth transfer. 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 offers additional liquidity upon the grantor's death, which should ease concerns if federal tax payments unexpectedly arise.

Prior Reports: 14-13; 13-46, 13-16, 12-22, 15-09.

Background

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 on a tax-efficient basis. The chief benefits of a grantor trust transaction for clients are the following: (1) sales and subsequent interest payments are not taxed to the grantor; and (2) the grantor pays all post-transaction income taxes of the trust, which are not considered an additional gift to the trust. The current economic and legacy planning environments are conducive for these transactions given that rates are still historically low, asset values may be depressed, sales are ignored for income tax purposes under current law, and transfer tax exemptions are at a temporary all-time high. Life insurance is often a complementary component of such legacy planning, with premium payments supported by the subsequent sale of assets sold or using the income they produce.

Planners should proceed with caution when planning and implementing installment sale and SCIN transactions with grantor trusts. The IRS has shown an interest in recent history in these transactions, scrutinizing both their estate and gift tax efficacy. The following summarizes these transactions, IRS challenges, and planning considerations in light of these events.

Overview: Grantor Trust Sale Transactions[i]

A client's sale of an illiquid asset to a grantor trust replaces a personally owned (taxable) asset and its future appreciation from the client's estate, with a non-appreciating, fixed income stream (a promissory note). 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 attached for a summary comparison***):

Installment Sales. 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[ii] or find other methods (such as personal guarantees[iii]) 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 in the grantor's estate. Thus, the term should be less than the grantor's life expectancy ("**LE**")). Given today's high transfer tax exemption amounts that are scheduled to sunset ($12.06 million in 2022 and estimated by the IRS to revert to approximately $6.8 million on January 1, 2026), "seeding" a grantor trust before the sunset is advantageous. Additionally, AFR rates have been steadily increasing from historic lows, which may mean now is a good time to lock-in a low rate before potential further rate increases.

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 transfer tax purposes.[iv] To avoid making a gift, the SCIN's FMV must equal the value of the asset sold, and the SCIN must include the value of 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 risk of early termination.[v] 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. The grantor transfers an asset 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 asset 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[vi] -- which can pose an additional funding requirement far more substantial than the "seed" gifts suggested for installment sales and SCINs.

Areas of Challenge

Grantor trusts and sales to grantor trusts have come under government scrutiny. For example, a proposal in the President's FY 2023 budget would treat transfers to and from grantor trusts and grantors as a recognition event for income tax purposes. Proposals to clamp down on the advantageous tax structing of grantor trust transactions is a recurring theme in tax reform. In addition, Tax Court cases and IRS internal guidance indicate an IRS interest in installment sale and SCIN transactions (see *Estate of Marion Woelbing v. Commissioner,*[vii] *Estate of Donald Woelbing v. Commissioner*,[viii] *Estate of Davidson v. Commissioner*,[ix] 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[x] including whether the trust has a demonstrable ability to pay the debt (i.e., sufficient assets in addition to those purchased).[xi] 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 trust-owned assets due to the grantor's retained interest (the right to receive note payments).[xii]

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

- **Target on SCINs**. The IRS has cited the interest-only payment feature and the grantor's lack of need for the income from the SCIN to support the argument there was never an intention to repay or enforce the debt evidenced by the SCIN.[xiv] Further, the IRS has targeted the valuation of SCINs and the risk premiums, claiming that SCINs cannot be valued using the § 7520 tables. Rather, SCINs should be valued based on a "willing-buyer/willing-seller standard,"[xv] 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.

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:[xvi]

- **Create a Bona Fide Debt**. Take steps to ensure the note is respected as debt and not re-characterized. 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, (iv) the clients financial solvency post transaction, and (v) 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 assets 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 or using a pre-existing trust with sufficient assets. If these options are not available, the client may consider obtaining personal guarantees from creditworthy individual beneficiaries of the trust.[xvii]

- **Follow Formalities**. The grantor and the trust must follow all formalities, including documenting and recording asset 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 *WRMarketplace No. 12-52*).[xviii] A defined value clause allows a grantor to fix the dollar amount of assets transferred to avoid unintended gifts if the IRS later challenges the asset valuations.

- **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 completely 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, 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 LE, then the trust will pay more than FMV for the assets sold, returning growth to the grantor's estate. In short, the economics could reverse.

Incorporating Life Insurance Into the Plan

Insurable sellers should consider the use of life insurance to hedge against the risk of unexpected gift or estate tax liabilities caused by an early death (e.g., inclusion of the promissory notes value or if the transferred assets failed to increase in value). A successful sale of assets to a grantor trust may also generate cash flow to the trust to facilitate payment of insurance premiums and avoid the need for further gifting by the grantor. 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

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Notes

[i] 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.
[ii] Some practitioners suggest a 10% rule-of-thumb for the seed gift (i.e., gift equals 10% of the value of assets sold).
[iii] 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.
[iv] *See Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), *acq. in result*, 1981-2 C.B. 1.
[v] *See* Code § 2512(b); Reg. § 25.2512-8.
[vi] *See* Treas. Reg. §§ 1.7520-3(b)(2)(i), 20.7520-3(b)(2)(i) and 25.7520-3(b)(2)(i).
[vii] T.C. No. 30260-13.
[viii] T.C. No. 30261-13.
[ix] T.C. No. 013748-13, *filed* June 14, 2013, *answer filed* August 9, 2013.
[x] *See Estate of Costanza v. Commissioner*, 320 F. 3d 595 (6th Cir. 2003), *rev'g,* T.C. Memo 2001-128.
[xi] *See Estate of Donald Woelbing v. Commissioner,* T.C. No. 30261-13.
[xii] 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 assets by the grantor with a retained interest.
[xiii] *See Estate of Donald Woelbing v. Commissioner,* T.C. No. 30261-13.
[xiv] *See Estate of Davidson v. Commissioner*, T.C. No. 013748-13.
[xv] *See* Treas. Reg. § 25.2512-8.

[xvi] 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.
[xvii] See discussion at Note 3 regarding issues to consider when using personal guarantees.
[xviii] See discussion in *WRMarketplace Nos. 12-34* and *12-52.*

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 leverage 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

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

Grantor Trust Transaction	Installment Sale	SCIN	Private Annuity
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 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