

Installment sale to a grantor trust

The concept

This approach begins with the client setting up a trust to which they will sell property for the benefit of a family member or members.

In the next step, the client seeds the trust with a gift of income, producing assets that are offset by the client's gift tax exclusion.¹

The client then enters into an installment sale with the trust.

Subsequently, the trust pays off the installment notes with the income from the gifted and purchased assets, leaving the remaining trust property for the benefit of the desired family member or members. Alternatively, the trust may purchase life insurance on the client for purposes of paying off the note at the client's death.

The trust is designed to contain provisions that cause the trust to be characterized as a "grantor" trust for income tax purposes. This means that:

- The client recognizes no gain or loss on the sale
- The client is not taxed on the interest payments received from the trust

From an estate and gift tax perspective, the basic idea behind the transaction is to have it characterized as a sale rather than a gift. In those situations where the client has used up their gift tax exclusions or the value of the transferred property exceeds their exclusions, a gift tax is avoided. In addition, if the total return on the assets sold to the trust exceeds the interest rate on the note, the excess is transferred gift tax-free to the trust beneficiaries. Since the client, as grantor, is required to pay the trust's income tax liability, the trust's assets grow income tax-free and the client's payment of those taxes is a gift tax-free gift to the beneficiaries.

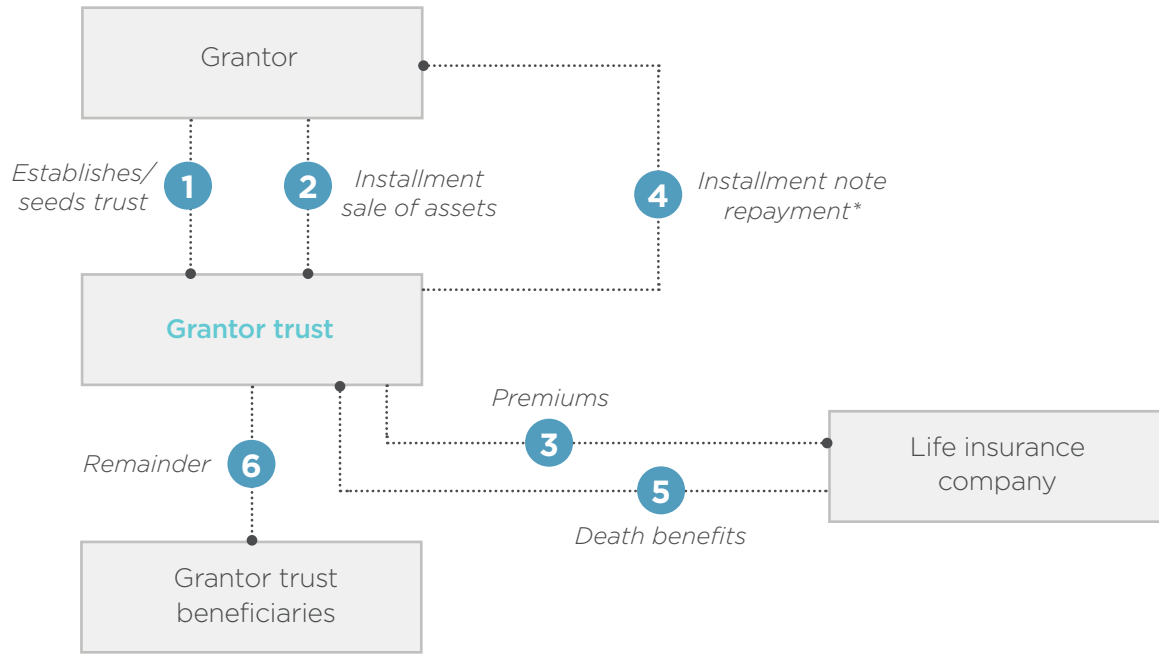
In structuring the transaction, care should be taken that the sales price represents the fair market value of the assets to be sold at the time of the sale and that the installment note is structured as an arms-length transaction with adequate interest to avoid the imputed interest rules of IRC § 7872. In any case, properly structured, the transaction freezes the value of the note in the client's estate with any increase in the value of the sold assets shifting to the trust and ultimately the beneficiaries' estate and gift tax-free.

The note may be structured to be paid in installments or as a balloon with annual interest payments that matures at the client's death. If the installment approach is taken and the client dies before all of the installments are paid, the unpaid amount will be included in the client's gross estate. If that will generate an estate tax liability, the client should consider purchasing a life insurance policy for the duration of the note to cover any potential tax liability. If a balloon note is employed, the client might consider making gifts to the trust with which a policy could be purchased by the trust for the purpose of paying off the note at the client's death.

Case study

Peter Brown is the sole shareholder of an S corporation which holds appreciating real estate with an underlying value of \$4,000,000.

How it works



- Peter recapitalizes the corporation and receives voting and non-voting stock. The non-voting stock represents \$4,000,000 of the underlying pro rata value of the S corporation's real estate but it may be valued by a qualified appraiser at a 30% discount for lack of marketability and lack of control for purposes of sale to a grantor trust at a price of \$2,800,000.
- Peter then creates a grantor trust and transfers \$280,000 to the trust as seed money and files a gift tax return offsetting the gift against his gift tax applicable exclusion. The beneficiaries of the trust are Peter's two children. Income and principal of the trust may be accumulated or distributed to the beneficiaries at the trustee's discretion. Upon termination of the trust, the principal and accumulated income will be distributed to the children pursuant to the terms of the trust.
- Peter then sells the S corporation stock to the trust for a cash down payment and an interest only balloon note totaling \$2,800,000 that reflects the 30% discount. Since Peter is considered the owner of the trust for income tax purposes, he will recognize no gain or loss on the sale.
- In subsequent years, the trust makes interest payments to Peter on the balloon note at the Applicable Federal Rate using distributions from the non-voting stock. By using the AFR and assuming that the stock is properly valued, there will be no taxable gift. In addition, because Peter is considered the owner of the trust for income tax purposes he will not have to recognize interest income upon receipt of the interest payments but he will be required to pay all of the trust's income taxes.
- Peter also makes gifts of cash to the trust each year that are sufficient for the trustee to purchase and pay premiums on a universal life policy covering Peter's life. The purpose of the policy is for the trust to use the death proceeds to pay off the balloon note to Peter's estate upon his passing.



¹ The purpose for having the client gift assets to the trust is to make sure that the trust has sufficient assets to pay the installment note. This addresses the problem that if the sold assets are the only source of funds for payment of the note and they are insufficient the IRS might argue that the transaction is a gift rather than a sale.

This material is not a recommendation to buy, sell, hold or rollover any asset, adopt an investment strategy, retain a specific investment manager or use a particular account type. It does not take into account the specific investment objectives, tax and financial condition, or particular needs of any specific person. Investors should work with their financial professional to discuss their specific situation.

Federal income tax laws are complex and subject to change. The information in this paper is based on current interpretations of the law and is not guaranteed. Neither Nationwide, nor its employees, its agents, brokers or registered representatives gives legal or tax advice. You should consult an attorney or competent tax professional for answers to specific tax questions as they apply to your situation.

Nationwide, the Nationwide N and Eagle and Nationwide is on your side are service marks of Nationwide Mutual Insurance Company. © 2018 Nationwide

NFM-14466AO.2 (02/18)