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Freezing Techniques: Installment Sales to Grantor Trusts
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Freezing techniques have been a popular way of reducing federal transfer taxes for a long time. A freezing technique is a transaction in which the value of an asset is frozen for purposes of determining the transfer tax base of the transferor, which is the total value of his or her adjusted taxable gifts during lifetime and his or her taxable estate at death. For example, a gift of Blackacre, when Blackacre is worth $100,000, will freeze the value of Blackacre forever when determining the value of the transferor's estate, assuming that Blackacre will not be brought back into the transferor's transfer tax base under Code § 2036, 2037 or 2038 because the transferor retained some right or power over Blackacre. The donor's adjusted taxable gifts would include the $100,000 gift, assuming that the transferor already used his or her annual exclusion for gifts made earlier in the year in which he or she gave Blackacre.

A sale of Blackacre for $100,000 would also freeze the value of Blackacre for transfer tax purposes, but the $100,000 taken back in exchange would increase the transferor's transfer tax base if he or she invested it in some other type of growth asset. A sale of Blackacre would result in capital gain to the extent of any unrealized appreciation (the excess of the fair market value of Blackacre over the transferor's basis in Blackacre). For example, if the transferor had a basis of $10,000 in Blackacre, the transferor would recognize $90,000 of capital gain, resulting in a capital gain tax of $18,000, assuming that Blackacre was a capital asset and that the capital gain tax rate is 20%. One type of freezing technique is a sale of an asset to a grantor trust, usually on an installment basis. The following series of questions and answers covers most of the salient tax and non-tax issues that arise when considering a sale of an asset to a grantor trust.

What is a grantor trust?

A grantor trust is a trust the assets of which are treated for income tax purposes as owned by someone other than the trustee under Code §§ 671 through 679. In most cases the owner is the person who transferred the assets to the trust. Because the grantor is treated as the owner of the assets in the trust, the grantor reports on his or her own income tax return the income generated by the assets in the trust that the tax law treats as owned by him or her. A trust will be a grantor trust in part when someone other than the nominal grantor transfers assets to the trust. More than one person may be treated as a grantor with respect to the same trust, in which case each would be treated as owning the assets he or she transferred or was treated as having transferred to the trust. In addition, a trust may be a grantor trust with respect to the income of the trust but not the principal, if the grantor's rights or powers affect only the income of the trust. In this case, the person transferring the assets to the trust would be taxed on the or-dinary income generated by the trust assets, but would not be taxed on the capital gains generated by a sale of trust assets.

Why does the Code treat the grantor as the owner of the assets in a grantor trust?

Historically, taxpayers have attempted to shift taxable income to family members in lower income tax brackets by using trusts over which a taxpayer retained certain rights or powers that courts viewed as giving the grantor such control over the assets that he or she should be treated as the owner of the assets for income tax purposes. After a series of cases holding that the transferor of the assets to the trust would be taxed on the income from those assets when he or she retained certain rights or powers over them, the Treasury Department issued regulations that described in detail when a person would be treated as the owner of assets he or she had transferred to a trust. The grantor trust rules contained in the Code-specifically, Code §§ 671 through 679-describe in detail the circumstances in which a grantor of a trust will be treated as the owner of some or all of the trust assets.

Who is the grantor of a grantor trust?

A person who transfers assets to a trust and retains either rights to the income or principal of the trust or the power to control the enjoyment of the income or principal of the trust will be treated as the grantor of the trust under the grantor trust rules. In some cases, someone other than the transferor of the assets to the trust may be treated as the grantor under the grantor trust rules. See Code § 678. Although in most installment sales to a grantor trust the transferor would be treated as the owner of the trust assets, there may be planning situations in which the person treated as the owner of the trust assets will be someone other than the transferor, such as the transferor's child. A person other than the original transferor will be treated as the owner of the trust assets under Code § 678 if he or she had the right to withdraw the income or principal from the trust and relinquished that right but retained some other right that would have caused him or her to be treated as the owner of the trust assets had he or she been the transferor of the assets to begin with.

What triggers grantor trust treatment?

Under Code §§ 674, 676 and 677, if the transferor retains aright to enjoy, or to control the enjoyment of, the income or principal of the trust or to revoke the trust, or if someone who is related or subordinate to the transferor and whose exercise or non-exercise of a power will not affect his or her interest in the trust has a right to control the enjoyment of the income and principal of the trust assets, the transferor will be treated as owning the trust assets for income tax purposes. In addition, if the transferor retains certain administrative rights or powers with respect to the trust assets, he or she will be treated as owning the trust assets under Code § 675. For example, if the transferor retains the right to substitute assets in the trust for other assets of equal value or the right to vote shares of stock transferred to the trust, the transferor will be treated as owning the assets. Code § 675(4). Also, if the income of the trust can be used to satisfy the transferor's obligation of support or to pay premiums on life insurance on the transferor's life, he or she will be treated as owning the trust assets that produce such income under Code § 677. Nevertheless, even though a person is treated as owning the assets for income tax purposes, he or she may not be treated as owning the assets for estate tax purposes. In other words, a transfer of assets to a trust may be a completed gift for transfer tax purposes, but not for income tax purposes. It is this dichotomy between the income tax rules and the transfer tax rules that allows an individual to be considered the owner of the assets for income tax purposes but not for estate tax purposes. Otherwise, the installment sale to a grantor trust would not have the desired result of excluding the transferred assets from the transferor's gross estate while avoiding recognition of income as a result of the sale.

Why should a grantor sell an asset to a grantor trust?

If a person who has transferred assets to a trust and retained such control over those assets so that he or she is treated as owning the assets for income tax purposes later sells appreciated assets to the same trust, he or she will not recognize any taxable income as a result of the sale. For income tax purposes, he or she is treated as selling the assets to himself or herself. Rev. Rul. 85-13, 1985-1 C.B. 184. In Rev. Rul. 85-13, the IRS rejected the holding in Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984), that a sale between a grantor and a trust treated as a grantor trust under Code § 675 was a taxable event. If the seller takes back an installment note in exchange for the transferred assets, the trust can pay for the assets over a period of time rather than at the time of the sale. If, however, the seller has not retained any rights that would cause the assets to be included in his or her estate, when he or she dies, the assets will not be includable in his or her estate. Furthermore, the seller will further reduce his or her taxable estate by paying income tax on earnings from the trust's investments, although the earnings will pass to the beneficiaries of the trust, resulting in a gift tax-free transfer.

What kind of assets should be sold to a grantor trust?

As with any freezing technique, assets that are expected to increase in value should be sold to a grantor trust. If the assets transferred to the trust do not increase in value at a rate faster than the interest rate that the trust is required to pay on the note to avoid a deemed gift under the below-market interest rate rules of Code § 7872, the transfer tax benefit will be limited to the income tax paid by the transferor on the income accumulated in the trust. Because under Code § 1361(c)(2)(A)(i) a grantor trust is an eligible shareholder of an S corporation, S corporation stock can be sold to a grantor trust without jeopardizing the company's S election.

What are the income tax consequences to the grantor as a result of the sale?

Because the grantor is treated as owning the assets in the trust for income tax purposes, a sale to the trust will be treated as a sale to the grantor, and, therefore, the grantor will not recognize any taxable income as a result of the sale under Rev. Rul. 85-13. If grantor trust status terminates before the grantor's death and the installment note received in exchange for the assets is still outstanding, the grantor would presumably recognize taxable income equal to the amount of gain represented by the unpaid portion of the note. See Madorin v. Commissioner, 84 T.C. 667 (1985); Treas. Reg. § 1.1001-2(c), Example (5); Rev. Rul. 77-402, 1977-2 C.B. 222. For example, if in the earlier example Blackacre is sold to the trust and the seller receives in exchange an installment note with a balloon payment at the end of 10 years, and grantor trust status is terminated at the end of five years, the seller would recognize taxable gain of $90,000, resulting in an $18,000 capital gain tax, assuming that the asset was a capital asset in the hands of the seller. Presumably, if the trust had paid half of the principal before grantor trust status terminated, the seller would only recognize 50% of the unrealized appreciation of Blackacre, or $45,000, and the capital gain tax would be $9,000. Note that the grantor trust status of the trust will terminate if the grantor relinquishes whatever rights or powers caused the trust to be treated as a grantor trust for income tax purposes. Although it would be inadvisable for the grantor to give up such rights or powers while the note is outstanding, grantor trust status will terminate at the grantor's death in any event. Whether death causes an income recognition event if the note is outstanding is discussed below. Interest paid to the grantor while the trust is a grantor trust will not be taxable income to the grantor and will not be deductible by the trust.

What are the income tax consequences to the trust as a result of the sale?

Because the grantor is treated as owning the assets in the trust, the trust will have the grantor's basis in the assets it purchases. If the grantor gave other assets to the trust in an effort to avoid inclusion of the assets purchased by the trust in the grantor's estate, the trust's basis in those assets will be the grantor's basis plus any gift and generation-skipping transfer (GST) tax paid on any unrealized appreciation in the assets under Code § 1015. Finally, neither the trust nor the grantor will recognize taxable income if the trustee uses appreciated assets to satisfy the note.

What are the gift tax consequences to the grantor as a result of the sale?

If the sale is for full and adequate consideration in money or money's worth, the seller will not be treated as making a taxable gift as the result of the sale of the assets to the trust. The installment note received in exchange for the assets will be treated as full and adequate consideration if the face amount of the note is equal to the fair market value of the assets sold to the trust and the interest paid on the outstanding balance of the note is determined under Code § 7872, which refers back to the "applicable federal rate" under Code § 1274. See Frazee v. Commissioner, 98 T.C. 554 (1992).

The applicable federal rate depends on the term of the note. If the term of the note is three years or less, the applicable federal rate is the short-term rate. If the term of the note is more than three years but no more than nine years, the applicable federal rate is the mid-term federal rate. If the term of the note is over nine years, the applicable federal rate is the long-term federal rate. The applicable federal rate in most cases will be less than the rate that must be used when valuing a retained interest in a grantor retained annuity trust (GRAT), which is 120% of the federal mid-term rate, required under Code § 2702(a)(2)(B), referring to the interest rate under Code § 7520. If the term of the note is over three years but no more than nine years, the applicable federal rate will always be less than 120% of the mid-term federal rate. Furthermore, both the short-term and long-term federal rates have historically been less than 120% of the mid-term federal rate. Consequently, one of the benefits that a sale to a grantor trust has over a GRAT is that the interest rate used to deter-mine the amount that must be payable to the grantor is lower in the installment sale than in the GRAT. In a GRAT, the property must appreciate in value by more than 120% of the federal mid-term rate before there has been a tax-free transfer of value to the remainder beneficiaries of the GRAT. In the case of an installment sale to a grantor trust, the property need only appreciate in value by more than the applicable federal rate.

An installment sale to a grantor trust should not be subject to the special valuation rules of Code § 2701 if the installment note is not treated as an equity interest and should not be treated as a retained interest under Code § 2702 if the installment note is not treated as an interest in the trust. See PLRs 9535026, 9436006.

What are the estate tax consequences to the grantor as a result of the sale?

If the transferor has not retained any rights over the assets in the trust that would cause the assets to be included in the transferor's estate, the assets in the trust, including the assets sold in exchange for an installment note, should not be includable in the transferor's estate at his or her death, regardless of whether the transferor dies before or after the note has been paid in full. The fact that the assets sold to the trust will not be included in the transferor's estate is a second advantage the installment sale to a grantor trust has over a GRAT. In the case of a GRAT, the transferred assets will be included in the transferor's estate if he or she dies before his or her annuity interest terminates.

In this regard, many commentators advise that before the sale the trust should have assets having a value equal to at least 10% of the amount of the installment note. The IRS has accepted this amount in several private letter rulings that address installment sales. In addition, 10% of the value of a corporation or partnership is the minimum value that can be assigned to the residual interest in such entity when applying the special valuation rules under Code § 2701(a)(4). The purpose of the 10% minimum is to prevent an argument that the transferor has retained an interest in the assets sold to the trust that would cause the assets to be included in the transferor's estate under Code § 2036(a)(1) because there are no other assets available to pay off the note. In addition, the payment of principal and interest on the note should not be related to the income produced by the assets sold to the trust and all trust assets should be liable to pay the note-again to avoid an argument that the transferor has retained an interest in the assets sold to the trust. See, e.g., Fidelity-Philadelphia Trust Co. v. Smith, 78 S. Ct. 730 (1958).

What are the GST tax consequences to the grantor as a result of the sale?

Because the assets initially given to the trust in the installment sale to a grantor trust technique will not be included in the grantor's estate, the estate tax inclusion period (ETIP) rules will not prevent the grantor from immediately allocating GST exemption to the gift of the assets to the trust. Additionally, the subsequent sale of assets to the trust will not be a generation-skipping transfer if it is for full and adequate consideration in money or money's worth. An ETIP is a period during which assets transferred to a trust will be included in the transferor's estate, other than because of the transferor's death within three years of the transfer. Under Code § 2642(f), GST exemption may not be allocated to a transfer during an ETIP. For example, if the transferor retains the right to the income from the assets transferred to a trust, he or she will not be able to allocate GST exemption to the transfer until the first to occur of the termination of his or her right to the income or his or her death. Note that, because the assets in a GRAT will be includable in the transferor's estate if the transferor dies before the transferor's interest in the GRAT terminates, the transferor will not be able to allocate GST exemption to the transfer until the termination of his or her interest in the GRAT. The ability to allocate GST exemption at the time of the initial gift is a third advantage of the installment sale technique over a GRAT.

What other techniques offer similar transfer tax benefits?

Similar benefits may be derived through the use of either an entity freeze or a GRAT. In an entity freeze, pursuant to the creation or recapitalization of a partnership or corporation, an older family member will receive a preferred interest in the entity that will not increase in value, even though the entity's assets, including intangible assets, do increase in value after the recapitalization. The holder of the preferred interest will be entitled to receive a preferred distribution on an annual basis. Because an entity freeze involves the creation of two classes of equity interest, an S corporation cannot be the subject of an entity freeze. In addition, because the preferred payment bya C corporation will be a dividend that will be includable in the recipient's income and not deductible to the corporation, resulting in a double tax (once on the income earned by the corporation to pay the dividend and once to the recipient when he or she receives the dividend), a C corporation is usually not a good candidate for an entity freeze. Consequently, most entity freezes today involve limited partnerships and limited liability companies (LLCs).

A typical entity freeze might work as follows. An older family member owns an office building that has a current fair market value of $1 million and a tax basis of $100,000. The older family member transfers the office building to an LLC and takes back both a preferred interest that has a value of $900,000, based on the present value of the preferred return on the preferred interest, and a residual interest worth $100,000, determined by subtracting from the $1 million the $900,000 value of the preferred interest. Note that the $100,000, which is 10% of the value of the office building, satisfies the 10% minimum residual value requirement under Code § 2701(a)(4). The older family member then sells or gives the $100,000 residual interest to a younger family member. Any future growth in the value of the office building will inure to the benefit of the owner of the residual interest, and not to the older family member.

To be treated as a partner for income tax purposes, the older family member may need to retain some minimal interest in the growth in the value of the office building, but the small growth interest will only reduce the transfer tax benefits slightly. If, however, the preferred payment is not actually made, Code § 2701(d) will require the value of the retained preferred interest to be increased when the older family member dies or transfers the preferred interest. The increase is meant to reflect the unpaid payments, compounded annually using the same rate of return that was used in determining the value of the retained interest for purposes of valuing the transferred residual interest at the time of the recapitalization. Consequently, it is imperative that the required payment be made on a timely basis. Under Code § 2701(d)(2)(C), the first payment can be delayed for up to four years, but subsequent payments will then have to be made on an annual basis after the first payment to avoid compounding. As in the case of an unpaid note pursuant to an installment sale to a grantor trust, only the value of the preferred interest will be included in the transferor's estate if the preferred payments have been made on a timely basis. Also, the transferred residual interest will have the same basis in the hands of the transferee as the transferor had, plus any gift or GST tax paid on the unrealized appreciation, unless the transferee purchases the residual interest, in which case his or her basis would be equal to the consideration paid.

In a GRAT, an older family member transfers an asset to a trust and retains the right to receive a fixed dollar amount for a period of time, after which the transferor's interest terminates and either the asset is distributed to the beneficiaries, usually younger family members, or the trust continues on for some period. Under Code § 2702, the value of the gift is the value of the transferred asset less the value of the retained annuity interest as long as the requirements contained in Code § 2702 and the regulations there under are satisfied. The present value of the retained interest for transfer tax purposes is determined using 120% of the federal mid-term rate under Code § 2702(a)(2)(B). Consequently, if the value of the asset transferred to the GRAT does not increase in value by more than 120% of the federal mid-term rate, there is no tax-free shifting of value to the remainder beneficiaries of the trust. Also, if the transferor dies before the end of the term, the assets in the GRAT will be included in the transferor's estate because either he or she has retained the right to enjoy the income from the transferred assets under Code § 2036(a), or, according to the IRS' recent ruling position, the remainder interest is included in his or her estate under Code § 2039, which includes the value of an annuity in a decedent's estate if he or she had any interest in the annuity at death. PLRs 9702027, 9451056, 9345035. If the decedent's estate is entitled to continuing payments, the present value of those payments would be includ-able in the decedent's estate under Code § 2033.

The benefit of a GRAT comes from the potential transfer tax-free shift of value to younger beneficiaries. This objective may be accomplished with minimal gift tax liability if the value of the donor's retained annuity interest is close to the value of the asset transferred to the trust. The IRS, however, has taken the position that the value of the retained annuity interest in a GRAT can never equal the value of the transferred asset. It is also possible to be relatively certain of the value of the asset for gift tax purposes by tying the amount of the annuity payment to a percentage of the value of the transferred asset, as finally determined for gift tax purposes, because any increase in value on audit would cause a corresponding increase in the amount of the annuity payment, resulting in a very small increase in the value of the remainder interest.

What advantages does an installment sale to a grantor trust have over an entity freeze or GRAT?

The benefits of an entity freeze have already been discussed. The disadvantage of an entity freeze is that the value of the preferred interest must be determined by a business appraiser using a rate of return based on market conditions. This amount may be considerably higher than the applicable federal rate that would be used for determining the interest rate in an installment sale to a grantor trust or the rate that would be used for valuing the retained annuity interest in a GRAT. In addition, if the qualified payment is not actually made to the transferor, the transferor's estate will be increased by the amount of the unpaid payment plus interest, compounded annually from the due date of the payment. Presumably, in the case of an installment sale to a grantor trust, if a payment is not made, the grantor will simply be treated as making a gift of the unpaid amount to the trust, with no additional gift or estate tax consequences.

In the case of a GRAT, if the grantor dies during the term of the GRAT, the assets will be includable in the grantor's estate. In addition, the value of the retained interest is based on 120% of the mid-term rate, which in most cases will be higher than the applicable federal rate used for purposes of determining the interest that has to be paid on the installment note in the case of an installment sale to a grantor trust. Also, the grantor cannot allocate GST exemption to the transfer until his or her interest terminates. Finally, distributions from a GRAT may only be made to the holder of the annuity interest during the term of the interest, while in the case of an installment sale to a grantor trust there are no restrictions on who may receive distributions before or after the note has been satisfied, although the grantor should not be a bene-ficiary to avoid inclusion of the trust assets in the grantor's estate.

What happens if the grantor dies before the trust pays the installment note?

The tax consequences are not entirely clear if the grantor dies before the installment note has been satisfied. If the trust pays the installment note in full while the grantor is alive, nothing in the trust should be included in the grantor's estate, provided that the grantor retained no powers or rights over the trust assets that would cause the trust assets to be included in his or her gross estate. In addition, principal payments will not be taxable income to the grantor, because the sale to the trust is disregarded for income tax purposes. Also, the grantor does not report interest paid on the note as taxable income, again because the trust is disregarded for income tax purposes.

Because the grantor trust status of the trust terminates when the grantor dies, some commentators argue that, if some or all of the note remains unpaid at the grantor's death, taxable income will be recognized-presumably the capital gain represented by the unpaid portion of the note (assuming that the assets sold to the grantor trust were capital assets). The gain may be treated as recognized by the grantor before his or her death and will be reported in the grantor's final income tax return unless the sale qualified for installment sale treatment for income tax purposes. In that case, the gain will be recognized by the recipient, usually the grantor's estate or beneficiary, as the note is paid off and the recipient will be entitled to a deduction for the federal, but not state, estate tax attributable to the inclusion of the unpaid balance of the note in the grantor's estate. If the gain is treated as recognized after the grantor's death, it could be argued that no gain is recognized because the installment note receives a step-up in basis equal to the value of the assets sold to the trust at the date of the sale.

Some commentators contend that the payments on the note after the death of the grantor are not items of income in respect of a decedent because they would not have been taxable to the decedent had the decedent received the payments during his or her lifetime on account of the grantor trust rules. Although there are precedents for treating the termination of grantor trust status during the grantor's lifetime as an income recognition event for income tax purposes (including the authorities cited above on income tax consequences to the grantor), the better reasoned view is that these precedents do not apply in the case of an installment sale to a grantor trust if the grantor dies with the note outstanding. Therefore, there should be no taxable income to the grantor or the grantor's estate at the grantor's death.

A second issue that arises if the grantor dies before the note is satisfied is whether there is any increase in the basis of the assets that were sold to the trust pursuant to the installment sale. Although a convincing argument can be made that the basis of such assets should be stepped up to the outstanding balance of the installment note, such a result seems inconsistent with the income tax consequences to the grantor. Certainly the assets would not be increased under Code § 1014(a) to their fair market value at the grantor's death, because they are not includable in the grantor's estate. Code § 1014(a) provides that an asset includable in the gross estate of the decedent obtains a new basis for income tax purposes equal to the fair market value of the asset at the date of death, or the alternate valuation date, if elected.

What are the potential drawbacks to an installment sale to a grantor trust?

Although the desired tax consequences of an installment sale to a grantor trust are based on existing statutes, regulations and case law, there is no authoritative statement by the Treasury or IRS approving all of the desired income and transfer tax consequences.

Although the IRS has ruled favorably on some of the issues, there are a number of issues still unresolved, principally what happens if the grantor dies before the note is satisfied in full and how much property needs to be in the trust before the sale takes place to ensure that the assets sold to the trust will not be included in the grantor's estate under a retained right to income theory.

What is the best way to ensure grantor trust treatment?

A detailed discussion of the grantor trust rules is beyond the scope of this article. Nevertheless, the safest way to ensure that the grantor will be treated as the owner of the trust assets for federal income tax purposes but not for federal transfer tax purposes may be to give an independent, nonadverse party the right to add beneficiaries to the trust. See Code § 674(c). For this purpose, an independent party is someone other than the grantor, the grantor's spouse, or any person who could be treated as having an interest in the trust adverse to the addition of beneficiaries to the trust. See Code § 672. In addition, the potential beneficiaries that could be added by the independent party should not be so restricted under the terms of the trust agreement that the potential beneficiaries could be treated as members of a class specified in the trust agreement. Such a restriction would prevent the trust from being treated as a grantor trust. Furthermore, a mechanism in the trust should be included in the trust agreement to ensure that there is always an independent party with this right, so that the death of the original independent party would not cause a termination of grantor trust status.

To what extent must the grantor fund the trust before the sale?

Many commentators feel that before the sale the trust should hold assets having a value equal to at least 10% of the value of the installment note that will be given in exchange for the assets sold to the trust by the grantor. These assets should be given to the trust by the same person who intends to sell assets to the trust, so that the seller will be treated as the owner of all the trust assets. Some commentators have suggested that the beneficiaries of the trust could guarantee the installment note, thereby avoiding the necessity of making a taxable gift to the trust. Although it could be argued that the guarantee of the note by a beneficiary should not be treated as a gift by the beneficiary to anyone unless the beneficiary actually has to pay off the note pursuant to the guarantee, the IRS could argue that the guarantee is a gift to other beneficiaries of the trust or, instead, to the grantor. The value of the guarantee for gift tax purposes would be uncertain. Making a taxable gift avoids the uncertainties involved in using a guarantee.

Why do some commentators refer to the technique as a sale to an "intentionally defective" grantor trust?

Referring to the transaction as a sale to an "intentionally defective" grantor trust highlights the fact that the grantor is purposefully creating a trust that has terms that will cause the grantor to be treated as the owner of the assets for federal income tax purposes but not for estate tax purposes. This contrasts with a situation in which an individual is transferring assets to an irrevocable trust with the dual goal of excluding the transferred assets from his or her estate and shifting the income from the assets for income tax purposes to individuals in lower income tax brackets.

Because the grantor of a grantor trust pays tax on the income earned by the trust that will ultimately pass to younger beneficiaries, however, the payment of income tax by the grantor could be viewed as an additional tax-free gift to the beneficiaries of the trust. In fact, the IRS took this position in PLR 9444033, where it indicated that the failure of a GRAT to reimburse the grantor for the income tax that the grantor pays on the income retained in the GRAT, which would be income in excess of the amount of the annuity payable to the grantor, would be a taxable gift by the grantor to the trust. The IRS withdrew the statement in PLR 9543049. Furthermore, it is unclear whether the same theory would apply to an installment sale to a grantor trust, which does not have statutory and regulatory rules to satisfy. In addition, it would be difficult for the IRS to claim that, because the grantor is paying income tax on income earned by the assets in a grantor trust, the grantor is making a taxable gift, because he or she is obligated under the Code to pay the tax. Harris v. Commissioner, 71 S. Ct. 181 (1950), among other cases, held that the payment of an obligation imposed by law should not result in a taxable gift.

Conclusion

As can be seen, an installment sale to a grantor trust may be a very effective way to transfer assets to younger family members at the value of the assets at the time of the transfer rather than at the grantor's death, but with no gift tax being paid on the transfer. The value of the payments received on the note will remain in the grantor's transfer tax base. The cost to the beneficiaries is the carryover basis that the trust will have in the assets sold to the trust. If, however, the installment sale to a grantor trust technique is to be used, the formalities should be followed to the letter, including a properly drafted trust agreement, installment note and any other documents required under state law to transfer ownership of the assets to the trust and to support the grantor's status as a bona fide creditor of the trust.

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