WHAT ARE THE DISADVANTAGES OF A TRADITIONAL INSTALLMENT SALE?

An installment sale has the following primary disadvantages:

The sold assets will not receive stepped-up basis in the event of your death.

If you were to hold your interest in the asset until your death, such interest will be included in your taxable estate and will receive a step-up in cost basis at that time to its then fair market value. In that case, a sale of the interest shortly after your death would not generate capital gain. However, by selling your interest in the asset to a grantor trust (and thereby removing the interest from your estate), the property will not obtain the step-up in cost basis upon sale or at your death. Thus, a subsequent sale of the interest by the Trustee would generate a capital gains tax even if the sale occurs immediately after your death. Despite this concern, if the maximum federal estate tax rate is much higher than the capital gains tax rate, the advantages outlined above (i.e., the avoidance of gift tax on the transfer and on the future income tax liability paid by you, the avoidance of estate tax on future appreciation, and the leverage of your GST Exemption) may outweigh this disadvantage.

Promissory note included in your taxable estate.

If you die before the promissory note is satisfied in full, it would be an asset held by you and included in your taxable estate.

Reversal of traditional IRS income tax position.

Even if you sold your interest in the asset to a grantor trust, the IRS may claim that the sale results in capital gain to you at the time of the transaction. If the IRS successfully took this position, you would recognize a capital gain on the sale of the interest at the time of transfer to the trust.

Estate may recognize capital gain.

If you die holding the promissory note, your estate may recognize capital gain on any unpaid principal.

IRS may treat the entire transaction as a gift.

The IRS may assert that the transaction was really a gift and not a sale. To avoid this risk, it is important that there is no pre-arrangement to forgive any interest or principal due under the promissory note, and the value of what is sold should be supported by the appropriate valuation, including, possibly, an appraisal. The transaction should be structured like a commercial or “arm’s length” transaction.

IRS may treat a portion of the transactions as a gift.

Even if the IRS is unsuccessful in attacking the entire transaction as a gift as described above, the IRS could attack the transactions on another front by asserting that the fair market value of the transferred interests is greater than the fair market value of the promissory note given back to you. The IRS could argue that (1) the promissory note was not worth its face value because the trust was not a creditworthy borrower or (2) the appraised value of

the interest in the asset was simply too low. It is important to support the sales price with an appropriate valuation or appraisal.

Sold interests may under-perform the IRS interest rate.

In this case, you will have actually increased the size of your estate and decreased the value sold to the trust because the interest and principal payments on the promissory note will exceed the value of the interests sold to the trust. Of course, this is always a risk that needs to be taken into account, and is difficult to predict or plan for.

Absence of express statutory sanction.

The installment sale to a grantor trust is a technique that does not have an express statutory sanction.