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Sales to grantor trusts

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A sale to a grantor trust is a wealth transfer strategy that may provide significant transfer tax benefits over a simple gift, but involves a bit more complexity.

Making lifetime gifts is a simple way to reduce estate taxes assessed at death. The annual exclusion ($17,000 per donee per donor in 2023) and the lifetime gift tax exemption ($12,92 million per donor in 2023) can be applied to make these gifts transfer tax-free. Once opportunities to make tax-free gifts are exhausted, other wealth transfer techniques can be employed to reduce or eliminate the tax on additional transfers.

A sale to a grantor trust is a strategy to consider that has the effect of "freezing" the size of an estate at current values and pushing the future appreciation of assets out of the transferor's estate.

What is a sale to a grantor trust?

Simply put, a sale to a grantor trust is a sale of assets rather than a gift of assets. Hence, there is no gift tax directly associated with this transfer. The seller typically selects assets that have a potential for growth. An irrevocable trust, structured as a grantor trust for income tax purposes, is the buyer of these assets. The purchase price is typically paid by the trustee of the irrevocable trust with a combination of cash and a promissory note. Once the sale is complete, the trust owns the growth assets and the seller holds a promissory note (a non-growth investment).

How does it work?

Client (referred to as the "grantor") engages estate planning counsel to assist in drafting an irrevocable trust for the benefit of their descendants which is structured as a grantor trust for income tax purposes (explained in more detail below). Grantor then makes a relatively small gift (usually cash) to the trust. Estate planning attorneys typically advise grantors to make a gift of an amount that is equal in value to at least 10% of the value of the assets to be purchased by the trust from the grantor as seed money. If the grantor's annual exclusions and lifetime gift tax exemptions have been used previously this gift may result in the payment of gift tax. The purpose of the 10% seed money is to provide the trust with some liquidity so that it isn't financing more than 90% of the purchase price, or so that it has some liquidity to be able to service the interest payments on the promissory note from a subsequent sale.

Once the trust has been created and funded, the grantor sells assets to the trust in exchange for an interest-bearing promissory note, or for a combination of cash and a promissory note. In effect, the grantor is financing the trustee's purchase of the assets. The promissory note provides for repayment of principal and payment of interest over a fixed term at the applicable federal rate or AFR. The AFR is published monthly by the Internal Revenue Service (IRS) and is used to determine the minimum interest rate for loans made during that month. Rates are set for short-term loans (three years or less), mid-term loans (three to nine years), and long-term loans (loans lasting more than nine years). Interest on loans should not be less than the AFR so that the loan is not considered by the IRS to be a gift. Principal can be re-paid periodically (making the note self-amortizing) or as a balloon payment at the end of the term.

For February 2023, here are the applicable federal rates based on annual compounding of interest:
Short-term: 4.47%
Mid-term: 3.82%
Long-term: 3.86%

If the assets sold to the trust appreciate in value at a rate in excess of the AFR, all appreciation in excess of that rate passes to the beneficiaries of the trust free of gift and estate taxes (and possibly generation-skipping transfer tax, if exemption is properly allocated).

Consider the following illustration: A grantor makes a gift of $2 million to an irrevocable grantor trust (using a portion of client's and spouse's lifetime gift tax exemption). The grantor then sells $20 million worth of limited liability company units to the trust in exchange for a nine-year promissory note, providing for interest payments only during the term of the note and a balloon principal payment at the end of the term. Assuming the value of the trust assets appreciates, the growth on $20 million at the end of nine years (after payment of interest and repayment of the note) is transferred tax-free to the remainder beneficiaries. In contrast, if the grantor had just given the $2 million to the trust and not engaged in the sale transaction, the $2 million plus nine years of appreciation is all that would be transferred. The sale transaction essentially enabled the grantor to leverage the $2 million gift at no additional transfer tax cost.

As previously mentioned, the irrevocable trust is structured as a grantor trust which means that the grantor is treated as the owner of the trust assets for income tax purposes. This treatment provides several additional benefits to the trust beneficiaries. First, the grantor, and not the trust, is taxed on the trust's income. This allows the trust assets to grow free of income tax because the grantor is paying the income taxes rather than the trust. Second, the sale of assets to the trust does not cause recognition of gain because, for income tax purposes, the grantor is treated as selling the assets to themselves.

If an individual already has an irrevocable grantor trust in existence with assets funded with gifts from prior transactions, such existing trust could possibly be used to sell additional assets to rather than creating a new trust. However, the trust terms and prior exemption allocations must all be analyzed to determine whether it makes sense from a tax efficiency perspective and whether the trust structure is in line with the client's goals.

When does it work best?

Many estate planning techniques are affected by the existing economic environment. A sale to a grantor trust is one such technique. The greatest results are achieved when asset values are depressed and interest rates are low. The benefits of this strategy are also enhanced when rapid, significant value growth occurs in the assets sold. In this type of economic environment substantial opportunity exists for wealthy families to transfer wealth to subsequent generations in a tax-efficient manner. Another potential scenario that can work well is when the asset being sold is one that will be appraised with discounts for lack for marketability or lack of control, such as a minority or non-voting interest in a private company. Such a scenario allows the grantor to transfer an asset into an irrevocable trust at a discounted value, which can maximize wealth transfer. Note, that a qualified appraisal may be required to determine the value, and any associated discounts, of the private company.

Advantages and disadvantages when compared to a GRAT

A grantor retained annuity trust (GRAT) is a similar wealth transfer strategy used to transfer a portion of the appreciation of an underlying asset to children, or a trust for their benefit, using little or no gift tax exemption. The grantor will fund the GRAT with assets that have a good potential for appreciation and will receive an annuity payment over the term of the GRAT (usually two to five years) based on the valuation of the assets and the applicable 7520 rate at the time of transfer. At the end of the GRAT term, any assets remaining will be distributed to a trust for the benefit of your children without additional gift tax.

One advantage of a sale to a grantor trust is the ability to leverage a grantor's generation-skipping transfer (GST) tax exemption. Gifts to individuals treated as more than one generation from the grantor (i.e. grandchildren) also may be subject to GST tax. Use of the sale to a grantor trust technique allows the grantor to allocate their GST tax exemption to the irrevocable trust upon creation. With a GRAT, the grantor can only allocate their GST exemption at the end of the term which often results in an inefficient use of exemption. As a result, the grantor can use a sale to a grantor trust to efficiently transfer assets to grandchildren or more remote descendants without incurring an additional layer of tax.

Another possible advantage of a sale to a grantor trust is that the risk of the grantor's death during the term of the strategy has less of an impact as compared to a GRAT. If the grantor dies during the term of the note it is broadly accepted that only the remaining note balance will be subject to estate tax. (Some attorneys have speculated that there could be a capital gains event on the grantor's death.) For a GRAT, except in extraordinary circumstances, the grantor must survive the term of the GRAT to achieve any estate tax benefits.

Yet another advantage of a sale to a grantor trust over a GRAT is that the promissory note can be structured as a balloon note only requiring interest payments during the term, which allows the growth asset to remain in the trust and grow before any significant payments on the note are required. In comparison, a GRAT typically requires larger annuity payments back to the grantor during the term which brings more of the asset back to the grantor in a shorter period.

One possible disadvantage of a sale to a grantor trust is the possibility that the assets decline in value. If the assets sold to the trust decline in value, the trust is still obligated to repay the note to the grantor. The trustee may need to use the seed money previously gifted as well as the assets sold to the trust. If the gift of the seed money used up part of the grantor's lifetime gift tax exemption (or actually generated gift tax), any amount re-paid to the grantor would be a waste of that exemption (or tax). However, with a GRAT, the grantor has typically not used any gift tax exemption, and any decline in value just means the assets all come back to the grantor.

Finally, even though sales to grantor trusts are well accepted among estate planning professionals and frequently employed by their clients, there is no specific case law or statutes condoning their use. In comparison, the GRAT is statutory and is specifically permitted in the Internal Revenue Code.

Conclusion

Gifts are a simple way to transfer assets to loved ones. A sale to a grantor trust is a more complex wealth transfer strategy that may provide significant transfer tax benefits over a simple gift. The effect of this strategy is to efficiently transfer growth and "freeze" estate values.

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