Estate Planning Studies®

Nov- Dec 2025

Lifetime Transfers: Part One: Installment Sales to Grantor Trusts

by Louis A. Mezzullo

GENERAL

Freezing Techniques

Freezing techniques have long been a popular way of reducing federal transfer taxes. A freezing technique is a transaction by which an asset's value is frozen for purposes of determining the transferor's transfer tax base, which is the total value of his or her adjusted taxable gifts during lifetime and his or her taxable estate at death. One type of freezing technique is a sale of an asset to a grantor trust, usually on the installment basis.

Installment sales to grantor trusts, sometimes referred to as "defective grantor trusts," have become a popular estate planning technique in recent years. The technique freezes the value of the transferred assets at their current fair market value, while the grantor receives the interest payments on the installment note, which are hopefully less than the growth in the value of the transferred assets. The transaction should not result in any income tax consequences because it is disregarded as a sale to oneself since the grantor is treated as owning the trust assets for income tax purposes. The installment sale method also allows the trust time to pay the principal, hopefully out of earnings produced by the trust assets, although the installment payments should bear no relationship to the earnings of the assets sold to the trust; otherwise the trust assets may still be included in the transferor's estate. I.R.C. § 2036(a)(1).

Grantor Trusts

A grantor trust is a trust, the assets of which are treated for income tax purposes under I.R.C. §§ 671 through 679 as owned by someone other than the trustee, and who is in most cases 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 trust assets.

A trust will be a grantor trust only in part if someone other than the person treated as the grantor also transferred assets to the trust. More than one person may be treated as a grantor with respect to the same trust, in which case each will 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 treated as 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 such a case, the person transferring the assets to the trust would be taxed on the ordinary income generated by the trust assets, but would not be taxed on the capital gains generated by a sale of trust assets.

"Intentionally Defective" Grantor Trust

Referring to the transaction as a sale to an "intentionally defective" grantor trust highlights the fact that the grantor is purposely creating a trust with 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 where an individual is transferring assets to an irrevocable trust with the dual goals 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, the payment of income tax by the grantor could be viewed as an additional tax-free gift to the beneficiaries of the trust.

Rev. Rul. 2004-64, 2004-2 C.B. 7, clarifies the tax treatment of a grantor who pays the income tax on the income earned by the trust assets. The grantor's payment of the income tax is not treated as a gift to the trust beneficiaries. In essence, the payment of the income tax is a tax-free transfer to the trust beneficiaries. If the trust agreement or state law requires the trust to reimburse the grantor for paying the income tax, the trust assets will be included in the grantor's estate under I.R.C. § 2036(a)(1). If the trust agreement prohibits reimbursement, there will be no inclusion.

If the trust agreement and state law are silent on the issue or give the trustee discretion to reimburse the grantor for payment of the income tax on the trust's income, then whether the trust assets are included in the grantor's estate depends on the facts and circumstances. In this case, the trust assets are likely to be included in the grantor's estate if: (1) the grantor can remove the trustee and appoint himself or herself as trustee; (2) there is an implied agreement that the trustee would always reimburse the grantor for the income taxes the grantor pays on the trust's income; (3) the grantor's creditors can reach the trust assets under local law; or (4) perhaps, the grantor can remove the trustee and appoint a related party, as defined in I.R.C. § 672 (c), as the trustee.

SALE TO A GRANTOR TRUST

Tax Benefits

If the grantor of a grantor trust later sells appreciated assets to the same trust, he or she will not recognize any taxable income as a result of the sale, since for income tax purposes he or she is treated as selling the assets to himself or herself. See, e.g., Rev. Rul. 85-13, 1985-1 C.B. 184, which 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 I.R.C. § 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.

From an estate planning perspective, unless the grantor has retained certain rights that would cause the trust assets to be included in his or her estate after death, the sale will remove the appreciating or income-producing assets from his or her estate, thereby resulting in a gift tax-free transfer of the appreciation or income to the trust beneficiaries. Furthermore, the grantor will further reduce his or her taxable estate by paying income tax on the earnings from the trust's investments, even though the earnings inure to the benefit of the trust beneficiaries and not the grantor. Finally, the ability to allocate the grantor's generation-skipping transfer (GST) exemption to the gift of the seed money to the trust means that the trust will have a zero inclusion ratio, as long as no additional gifts are made to the same trust to which additional GST exemption is not allocated.

Disadvantages

While 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 Department or IRS approving all 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, such as the income tax consequences 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. In the Karmazin case (Docket # 2127-03) and the Woelbing case (T.C. No. No. 030261-13), the IRS raised a number of issues in connection with the installment sale technigue, including I.R.C. §§ 2701 and 2702. Both cases were settled.

Funding of a Grantor Trust

Many commentators feel that 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 to be sold to the trust by the grantor. The same person who intends to sell assets to the trust should give these 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 trust beneficiaries could guarantee the installment note, thereby avoiding the necessity of making a taxable gift to the trust.

Non-Tax Benefits

An installment sale to a grantor trust can be used to deal with a situation where an individual owns a business and wishes to transfer most, if not all, of the business to one or more, but fewer than all, of his or her children and still treat all the children equally. By using the installment sale technique, the individual receives back a note that can then be left to the other children if the individual dies before the note is paid, and the proceeds of which can be invested in another asset that can be left to the other children, without incurring any income tax on the unrealized appreciation in the business.

While the value of the business will be frozen at the time of the sale for purposes of determining the individual's wealth, any interest payable on the note and earnings on principal payments that are invested will increase the individual's wealth, although perhaps at a different rate than the growth of the business. It could be argued that if the children receiving the business are actively participating in the business, any increase in the value of the business after the sale is attributable to their efforts.

Example

Mr. Entrepreneur owns 100 shares of the stock of an S Corporation having a fair market value of $20,000,000. He also owns commercial real estate having a fair market value of $20,000,000. He has four children, two active in the business and two not active in the business. He wants to treat the children equally, but does not want the children who are inactive in the business to have any ownership in the business.

To carry out his desires, Mr. Entrepreneur could do the following:

- Recapitalize the corporation to create 10 shares of voting stock and 90 shares of nonvoting stock.
- Sell 90 shares of nonvoting stock to a grantor trust having as its beneficiaries the two children who are active in the business.
  Assuming a 50% combined discount for lack of control and marketability, the value of the stock sold to the trust would be $9,000,000 (90% times $20,000,000 = $18,000,000 times 50% = $9,000,000).
- Transfer the commercial real estate to a limited liability company (LLC) in exchange for a 90% nonvoting membership interest and a 10% voting membership interest.
- Sell the 90% nonvoting membership interest in the LLC to a grantor trust having as its beneficiaries the other two children.
  Assuming a 50% combined discount for lack of control and marketability, the value of the LLC interests sold to the trust would be $9,000,000 (90% times $20,000,000 = $18,000,000 times 50% = $9,000,000).
- To avoid a number of potential tax problems, Mr. Entrepreneur should contribute $1,000,000 to each of the trusts, using some of the combined gift tax applicable exclusion amounts of him and his wife ($13,990,000 each in 2025).
- At his death or the death of the survivor of him and his wife, Mr. Entrepreneur would leave the voting stock in the corporation to the two children active in the business and the remaining membership interests in the LLC to the other two children.

Appropriate Assets to 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. However, if the assets transferred to the trust do not appreciate at a rate faster than the interest rate the trust is required to pay on the note to avoid a deemed gift under the below-market interest rate rules under I.R.C. § 7872, the transfer tax benefit will be limited to the income tax paid by the transferor on the income accumulated in the trust. Because a grantor trust qualifies as an eligible shareholder of an S corporation, a grantor can sell S corporation stock to a grantor trust without jeopardizing the S corporation election. I.R.C. § 1361(c)(2)(A)(i).

TAX CONSEQUENCES

Income Tax

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. See Rev. Rul. 85-13, supra. If grantor trust status terminates before the grantor's death while the installment note received in exchange for the assets is still outstanding, the grantor presumably recognizes 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); and Rev. Rul. 77-402, l977-2 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 providing for a balloon payment of principal at the end of ten years and grantor trust status is terminated after five years, the seller would recognize taxable gain of $90,000, resulting in an $18,000 capital gain tax, assuming

the asset was a capital asset in the hands of the seller. Presumably, if the trust had paid half of the principal before the grantor trust status terminated, the seller would recognize only 50% of the unrealized appreciation of Blackacre, or $45,000, and the capital gain tax would be $9,000.

A trust's status as a grantor trust terminates upon the grantor or other person treated as the grantor relinquishing whatever rights or powers he or she held that caused the trust to be treated as a grantor trust. Although it would be inadvisable for the grantor (or other person whose rights or powers over the trust assets cause the grantor to be treated as the owner of the trust assets) to give up such rights or powers while the note was 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 then outstanding is discussed below.

Interest paid to the grantor while the trust is a grantor trust will not be taxable income to the grantor or deductible by the trust. Since the grantor is treated as owning the assets in the trust, the trust will have the same basis in the assets it purchases from the grantor as the grantor had. If the grantor has gifted other assets to the trust in an effort to avoid inclusion of the sold assets in the grantor's estate, the trust's basis in the gifted assets will be the grantor's basis plus any gift and generation-skipping transfer (GST) tax paid on any unrealized appreciation in the assets (but not in excess of the gifted asset's fair market value at the time of the transfer). I.R.C. § 1015. Finally, neither the trust nor the grantor will recognize taxable income if appreciated assets are used to satisfy the note.

Gift Tax

If the sale of the assets to the trust is considered made for full and adequate consideration in money or money's worth, the seller should not be treated as making a taxable gift as a result. The Internal Revenue Service (IRS) will treat the installment note received in exchange for the assets 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 equal to the applicable federal rate (AFR) under I.R.C. § 1274. See Frazee v. Commissioner, 98 T.C. 554 (1992).

The AFR depends upon the term of the note. If the term of the note is three years or less, the AFR is the short-term rate, which was 4.33% (compounded annually) for January 2025. If the term of the note is more than three years but no more than nine years, the AFR is the mid-term federal rate, which was 4.24% (compounded annually) for January 2025. If the term of the note is over nine years, the AFR is the long-term federal rate, which was 4.53% (compounded annually) for January 2025.

The AFR in most cases will be less than the I.R.C. § 7520 rate that must be used when valuing a retained interest in a grantor retained annuity trust (GRAT). I.R.C. § 2702(a)(2)(B). The § 7520 rate is 120% of the federal mid-term rate, and for January 2025 it was 5.20%. If the term of the note is over three years but no more than nine years, the AFR will always be less than 120% of the mid-term federal rate. Furthermore, generally the short-term AFR and, occasionally, the long-term AFR have been less than 120% of the mid-term federal rate.

Consequently, one of the benefits a sale to a grantor trust has over a GRAT is that the minimum required interest rate for determining the amount that must be payable to the grantor (as interest pursuant to the installment sale or the value of the retained annuity interest in the case of the GRAT) is generally 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, while in the case of an installment sale to a grantor trust, the property needs only to appreciate in value by more than the AFR.

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

Estate Tax

Unless the transferor has retained rights over the assets in the trust that would cause the assets to be included in his or her estate, the assets in the trust, including the assets sold in exchange for an installment note, should be excluded from the transferor's estate at his or her death, regardless of whether he or she 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 regardless of when the transferor dies is a second advantage the installment sale to a grantor trust has over a GRAT, since in the case of a GRAT, the value of some or all of 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 already hold assets having a value equal to at least 10% of the amount of the installment note

so as to prevent an argument that the grantor has retained an interest in the sold assets that would cause the assets to be included in the grantor's estate under I.R.C. § 2036(a)(1) because there are no other assets available to pay off the note. The IRS in at least one private letter ruling dealing with the installment sale technique apparently accepted the 10% amount. PLR 9535026. In addition, 10% of a corporation or partnership's value is the minimum value that can be assigned to the residual interest in such entity when applying the special valuation rules under I.R.C. § 2701(a)(4). Petter v. Commissioner, T.C. Memo 2009-280, involved installment sales of LLC units to grantor trusts, where the donor gave the trusts gifts of LLC units before the sales equal to 10% of the value of the total units held in the trusts after the sales. However, the sales to the grantor trusts were not at issue in the case.

Finally, principal and interest payments 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, 356 U.S. 274 (1958).

GST Tax

Because the assets initially given to a trust to establish it as a grantor trust will not be included in the grantor's estate, the estate tax inclusion period (ETIP) rules will not prevent the grantor from immediately allocating his or her GST tax exemption ($13,990,000 for transfers in 2025) to the gift. 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. I.R.C. § 2642(f)(3). Under I.R.C. § 2642(f), a transferor's GST tax 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 his or her 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 some or all of the assets in a GRAT will be includible 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 his or her GST exemption to the transfer until the termination of his or her interest in the GRAT.

The ability to allocate the GST exemption at the time of the initial gift is a third advantage of the installment sale technique over a GRAT. Additionally, the subsequent installment 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.

DEATH OF GRANTOR BEFORE SATISFACTION OF NOTE

Introduction

The tax consequences are not entirely clear if the grantor dies before the installment note has been satisfied. Regardless of whether the installment note has been paid in full before the grantor dies, nothing in the trust should be included in the grantor's estate, provided 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. The note, of course, will be included in the grantor's estate for estate tax purposes.

It is arguable that the note could be valued at less than its face value under Treas. Reg. § 20.2031-4, which reads:

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.

Note that proposed Treas. Reg. § 20.7872-1 prohibits the discounting, at other than the applicable federal rate, for estate tax purposes, of any gift term loan made by a decedent with donative intent after June 6, 1984. However, this is only a proposed regulation issued in 1985. In addition, because the proposed regulation applies to gift term loans made with donative intent, it should not apply to an installment note received in a sale transaction designed to avoid any taxable gift.

Termination of Grantor Trust Status at the Grantor's Death

Because the grantor trust status of the trust terminates when the grantor dies, some commentators argue that the estate will recognize taxable income if some or all of the note remains unpaid at the grantor's death. Presumably, such income will be in the form of capital gain equal to the unpaid portion of the note less a portion of the

grantor's basis (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 it will be reported in the grantor's final income tax return unless the sale qualified for installment sale treatment for income tax purposes, in which 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 there is no taxable gain 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 earlier, 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 and, therefore, there should be no taxable income to the grantor or the grantor's estate at the grantor's death.

For a discussion of this issue, in which the authors take the position that gain should not be realized at death, see Manning & Hesch, "Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements," 24 TAX MGMT. EST., Gifts & TR. J. 3 (1999).

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. While 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. However, if income is recognized by the estate or beneficiary receiving the note, the trust's basis in the property should be increased by the amount of gain recognized.

Certainly, the basis of the assets would not be increased under I.R.C. § 1014(a) to their fair market value at the grantor's death, because they are not includible in the grantor's estate. I.R.C. § 1014(a) provides that an asset at the date of death, or the alternate valuation date if elected.

CONCLUSION

An installment sale to a grantor trust may be a very effective way to transfer assets to younger family members at their current value, as opposed to their presumably appreciated date-of-death value, without incurring any gift or income tax on the transfer. The value of the principal and interest payments received on the note will remain in the grantor's transfer tax base. The disadvantage to the beneficiaries is that they will end up with the same carryover basis that the trust will have in the assets sold to the trust.

However, if the 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. Finally, the installment sale to a grantor trust should be compared with other techniques, such as a preferred equity interest transaction or a GRAT and the use of a self-canceling installment note (SCIN) or a private annuity should be considered if the grantor is in poor health but not terminally. These techniques will be discussed in Part Two.

* Louis A. Mezzullo is Of Counsel with the International Law Firm of Withers Bergman LLP. His areas of practice include estate planning, business succession planning, and planning for distributions from qualified benefit plans and IRAs. He has written 14 books and numerous articles on these subjects. He also serves as an expert witness in the areas of his practice, including malpractice cases. He is past president of the American College of Trust and Estate Counsel, past chair of the American College of Tax Counsel, and past chair of the American Bar Association Section of Real Property, Trust and Estate Law.