

Promissory Notes: A Way to Lock In Estate Tax Exemption Amounts

Unless one political party gains control of the presidency and both houses of Congress in the next election, gift and estate tax exemption amounts will likely sunset at the end of 2025. That means gift and estate tax exemption amounts will decrease from \$12.92 million in 2023 (\$25.84 million for married couples) to approximately \$7 million in 2026 (\$14 million for married couples). This situation has some clients exploring options to “lock in” the additional \$6 million (\$12 million for married couples) of currently available exemption amounts scheduled to be lost starting in 2026. If possible, it is best to gift “traditional” assets, such as stocks, bonds, real estate and closely held business interests. However, the thought of gifting and losing control of significant amounts of traditional assets is concerning for many taxpayers. If this is the case, the use of a promissory note may be an option.

Promissory Notes and Grantor Trusts

Promissory note planning often occurs in conjunction with irrevocable grantor trusts. Grantor trust status can be achieved by allowing the grantor of an irrevocable trust to exchange trust-owned assets for personally owned assets of equivalent value. This is referred to as a “swap power” or the “power to substitute.” Swap powers can be used to accomplish a variety of income and estate tax objectives. When trying to lock in current estate tax exemption amounts while retaining control of traditional assets, clients will create an irrevocable grantor trust, such as a dynasty trust or spousal lifetime access trust (SLAT), and fund the trust with traditional assets. After some time has passed, the trust’s traditional assets are swapped out to the grantor, partially in exchange for a promissory note.¹ In this way, the grantor attempts to lock in the current estate tax exemption amount of \$12.92 million rather than risking that it will drop to \$7 million in 2026.²

Can a promissory note really be swapped for traditional assets? The answer is yes, if done properly. In a Louisiana court case, a grantor created several grantor trusts and sought to swap traditional assets, including ownership interests in the New Orleans Saints football team and the New Orleans Pelicans basketball team out of the trusts in exchange for promissory notes and real estate. The trustee claimed the proposed swap was a loan and refused to release any traditional assets from the trust to the grantor. The court upheld the proposed swap as valid. Factors the court cited in favor of the swap were:

- » The promissory notes were secured³
- » Qualified appraisals of the traditional assets being exchanged out of the trust were obtained
- » The notes contained valuation adjustment clauses to ensure the note values would match the value of the assets being taken out of the trust
- » The notes required the payment of adequate interest⁴
- » Real estate and other assets were swapped into the trust with the promissory notes⁵

While finding that the trustee had a duty to verify that swapped assets were of equivalent value, the court ruled that the trustee did not have the ability to refuse the grantor’s request for a swap. The following year, the matter came before the court again because the new trustee, who was appointed by the former trustee, was still refusing to do the swap. The court issued a terse opinion in favor of the grantor.

Final Comments

Using a promissory note as part of a swap transaction with a grantor trust can provide significant estate tax benefits and lock in current estate tax exemption amounts. At the same time, it is a complicated transaction that requires the use of qualified professionals.

Please contact our estate planning specialists at EPS@ceritypartners.com for information on how promissory notes might be incorporated into your estate plan or for help with any other estate planning needs.

¹ Despite the IRS stating that assets gifted under the current estate tax exemption amount will not be “clawed back” into a decedent’s estate if they pass away when a lower estate tax exemption amount is in effect, the IRS later issued proposed regulations that required clawback under certain situations. The proposed regulations do not appear to apply clawback when promissory notes are swapped for traditional trust assets, even if the promissory note is not paid off within 18 months of death. Regardless, a prominent estate planning organization has requested IRS clarification to avoid ambiguity.

² Another option sometimes used is to have the donor initially fund an irrevocable grantor trust (SLAT or generation-skipping trust) with a promissory note payable to the trust. This is more difficult to implement and has more risk than funding the trust with traditional assets and then swapping them out for a promissory note.

³ The cases cited by the trustee finding that the swap was really a loan involved unsecured promissory notes.

⁴ The applicable federal rate, a below market rate, was used for the unsecured promissory notes in *In re Condiotti*. In that Colorado case, the court held the proposed swap was a disguised loan.

⁵ In Rev. Rul. 85-13, the IRS determined that a grantor’s “receipt of the entire corpus of the trust in exchange for [the grantor’s] unsecured promissory note constituted an indirect borrowing of the trust corpus.”

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