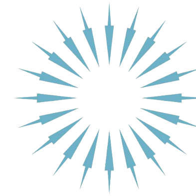

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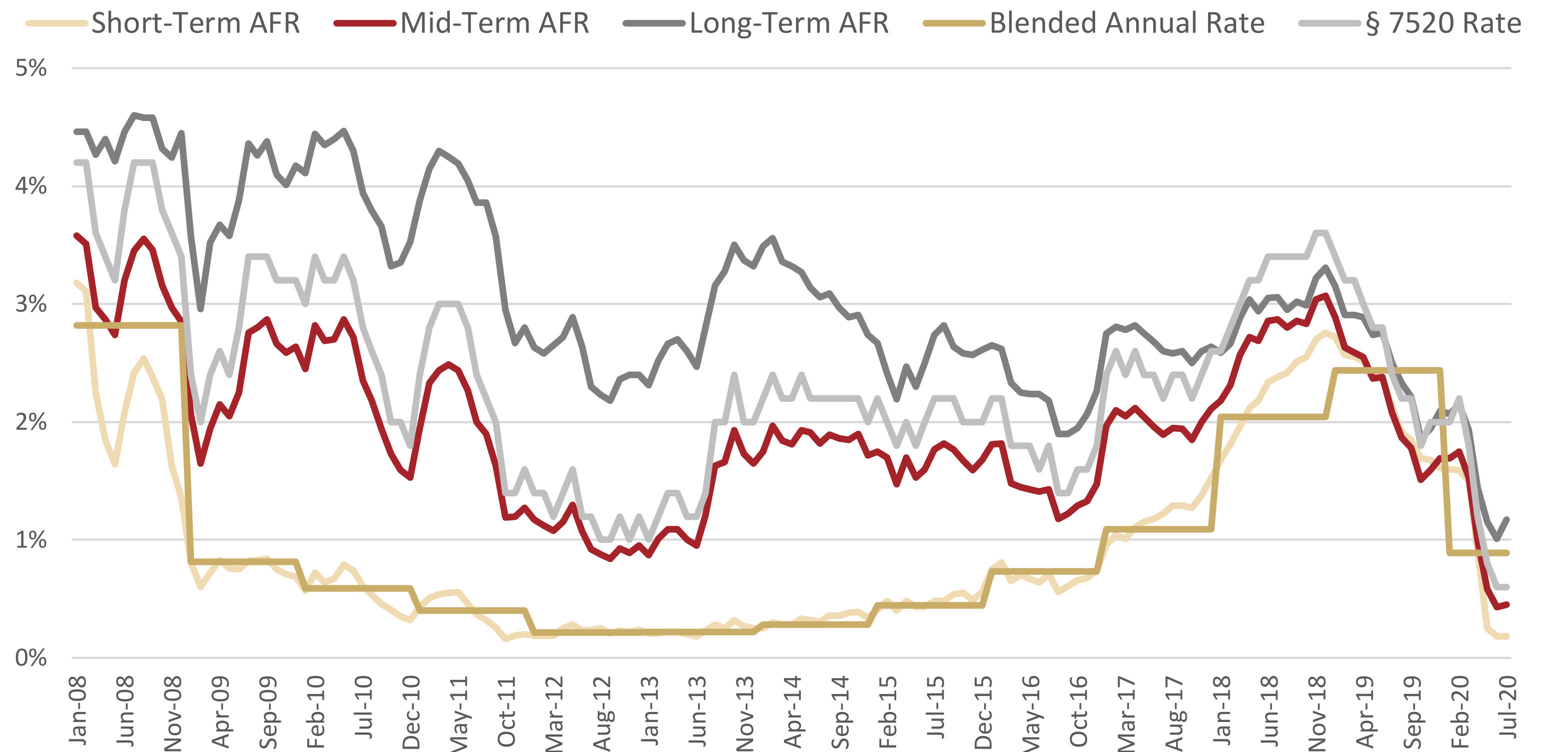
Interest Rates at Historic Lows, Wealth Transfer Opportunities at Historic Highs

The Applicable Federal Rate (AFR) and § 7520 Rate have fallen to historic lows due to the Federal Reserve reducing short-term rates in response to the economic contraction caused by the COVID-19 pandemic and Treasury Bond yields following. Although COVID-19 has caused a great deal of upheaval and uncertainty, **low AFRs can increase the effectiveness of various estate freeze techniques, such as intrafamily loan, installment sale or certain gift strategies.** Moreover, the fair market value of assets held by high-net-worth individuals may have diminished due to economic or stock market volatility and, if expected to rebound in value with a subsequent recovery, these strategies can be **even more advantageous if assets with temporarily depressed values are thereby transferred to family members (or trusts therefor) and subsequent growth occurs outside the transferor's taxable estate.** For those able and willing to act, immense planning opportunity can be realized during this tumultuous time.

Below are the AFRs and § 7520 Rate for July 2020 and a chart showing historical rates:

	Period of Compounding			
	Annual	Semi-Annual	Quarterly	Monthly
Short-Term AFR (Term loans not more than 3 years)	**0.18%**	**0.18%**	**0.18%**	**0.18%**
Mid-Term AFR (Term loans over 3, not more than 9 years)	**0.45%**	**0.45%**	**0.45%**	**0.45%**
Long-Term AFR (Over 9 years)	**1.17%**	**1.17%**	**1.17%**	**1.17%**

2020 Blended Annual Rate (Demand Loans)	**0.89%** (average of January and July Short-Term AFRs for the year)
§ 7520 Rate (Present value of annuity, interest for life or term of years, or remainder or reversionary interest)	**0.6%** (120% of the Mid-Term AFR rounded to nearest 0.2%)



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ESTATE FREEZE TECHNIQUES, IN GENERAL

Generally speaking, estate freeze techniques are gift, loan or sale strategies that "freeze" or limit the value of property transferred in the transferor's taxable estate for federal estate tax purposes, allowing all or a portion of its subsequent appreciation or income to escape gift or estate tax with respect to the transferor.

An outright gift can be an estate freeze because the amount includible in the transferor's taxable estate is its fair market value (FMV) at the time the gift is made. All subsequent appreciation or income is not subject to gift or estate tax with respect to the transferor. Even gift taxes paid on an outright gift escape estate tax if the transferor survivors at least three years pursuant to IRC § 2035(b). Outright gifts are the baseline for evaluating other freeze techniques. If a technique does not outperform a gift, the tax and non-tax reasons for considering it should be evaluated by a professional estate planner.

A loan can be a freeze technique. Structured properly, the amount includible in the lender's taxable estate is limited to the FMV of the promissory note receivable and payments received. All excess appreciation from investment of the cash by the borrower from the date of the loan escapes estate or gift tax with respect to the lender.

An installment sale can be another freeze technique for similar reasons as a loan. The amount that is includible in the seller's taxable estate is limited to the FMV of the promissory note receivable and payments received. All excess appreciation on, or income from, the property sold from the date of the sale can escape estate or gift tax with respect to the seller if structured properly.

A Grantor Retained Annuity Trust (GRAT) can be an estate freeze should the grantor survive the trust term, in which case the amount includible in his or her taxable estate is limited to the portion of the initial transfer treated as a taxable gift plus the value of annuity payments received over the term. All appreciation and accumulated income in excess of the retained annuity payments can escape estate and gift tax with respect to the grantor.

A Charitable Lead Annuity Trust (CLAT) can also be an estate freeze because the amount includible in the transferor's taxable estate is the portion of the initial transfer that is treated as a taxable gift – the present value of the remainder interest. The rest of the initial transfer escapes gift taxation through the unlimited charitable gift tax deduction and the remainder value at the end of the trust term, if transferred to a third party, is not subject to gift or estate tax with respect to the transferor.

Leveraging the technique by freezing off a valuation discount can enhance the above techniques. If the FMV of the property gifted, loaned or sold can be legitimately discounted for gift tax purposes due to entity planning, economic recession and/or market volatility, the amount includible in the transferor's estate with respect to the transfer can be reduced and a greater amount of economic value due to subsequent appreciation on, and/or income from, the underlying property can be shifted to the recipient, escaping gift and estate tax with respect to the transferor.

Loans, installment sales, GRATs and CLATs, can become even more effective as wealth transfer strategies in lower interest rate environments and can be enhanced with life insurance, as discussed in detail below.

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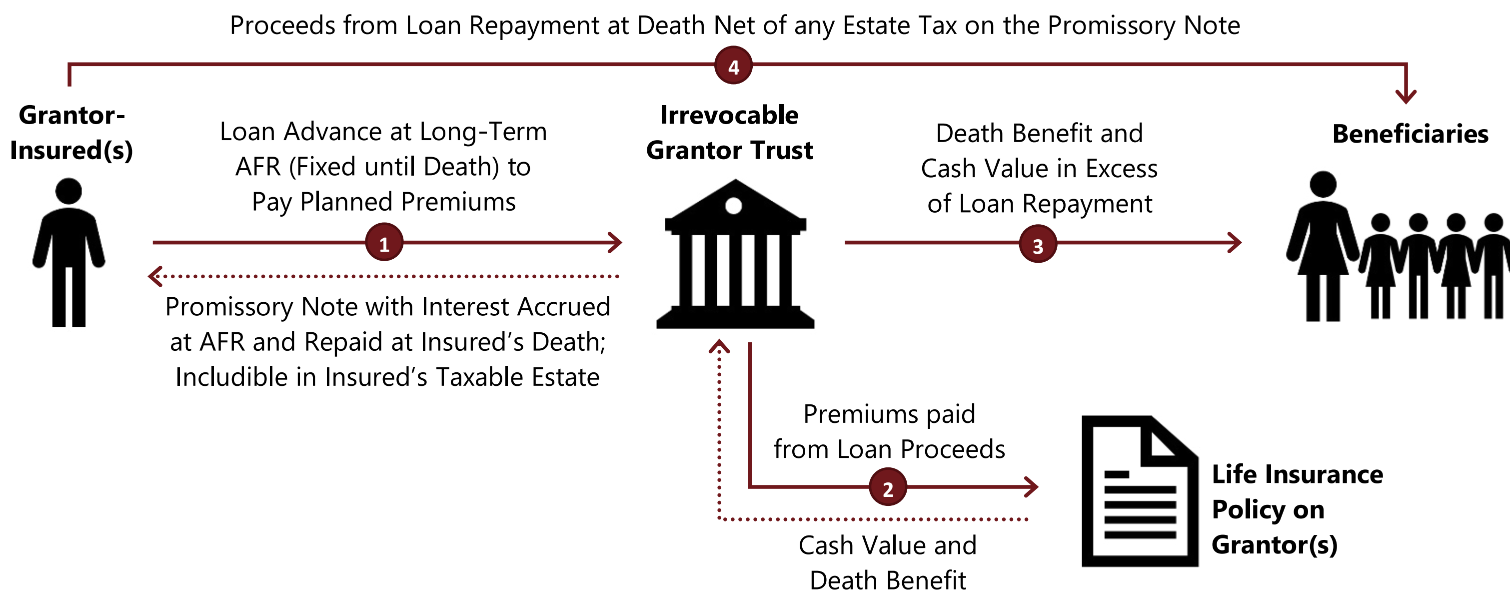
STRATEGY 1 INTRAFAMILY SPLIT DOLLAR LOAN ARRANGEMENT

HOW IT WORKS



1. **Grantor-Insured makes one loan advance to the Trust, repayable upon his or her death, of enough to pay all planned premiums locking in the current long-term AFR (1.17% for July 2020) on the entire loan for life.** [1]

   Loan advances can alternatively be made annually as premiums come due, in which case each advance will be subject to the AFR in effect the month the loan is made. The promissory note is generally non-recourse and, to avoid taxable gifts, the annual interest can be accrued at the AFR.[2]

2. **Trustee pays the first premium and can invest the balance of additional loan proceeds for premiums in years 2+, if any, in a side fund or the carrier's premium deposit account, if available, at his or her discretion.**

   Paying premiums over multiple years can avoid classification as a Modified Endowment Contract (MEC), thus preserving tax-favorable treatment of distributions during the Insured's lifetime, if necessary. The Grantor is generally treated as the owner of Trust property for income tax purposes and responsible for taxes payable on the Trust's taxable income. There should not be any taxable income generated by the life insurance if structured and managed properly.[3]

3. **Proceeds in excess of the loan repayment amount are transferrable to Beneficiaries estate tax free and the death benefit proceeds received are generally not includible in the Trust's taxable income.**[4]

   Withdrawals or loans from cash value could alternatively be taken during life income tax free (assuming the policy stays in force until death and never becomes a MEC) by the Trustee to accelerate the loan repayment or make distributions to Beneficiaries.[5]

4. **Loan repayment proceeds received by Grantor-Insured's estate at death, net of estate and income tax on the note, is transferrable separately to Beneficiaries.**

   The only portion of the interest that is taxable income to the estate should be only the amount that specifically accrues as OID in the year of death when grantor trust status ends (all prior years interest is disregarded under the grantor trust rules).[6] The promissory note could alternatively be transferred to the Trust by the estate and terminated, which may require future availability and allocation of Generation Skipping Transfer (GST) Exemption to preserve GST exempt trust status, if applicable, or donated to charity to eliminate the taxes on it through the charitable deduction.

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STRATEGY 1: INTRAFAMILY SPLIT DOLLAR LOAN ARRANGEMENT

HOW IT BENEFITS FROM LOW INTEREST RATES

1. **Locking in a low AFR for life helps reduce taxable gifts needed to help the trustee pay interest to the Grantor-Insured; or**
2. **With accrued interest designs that avoid taxable gifts, it can minimize the loan receivable includible the Grantor-Insured's taxable estate allowing more policy proceeds to transfer to Beneficiaries estate and gift tax free; and**
3. **Reduces the pressure on policy performance to generate cash value or death benefit proceeds to repay the loan.**

HYPOTHETICAL ILLUSTRATIVE EXAMPLES

Although annual loan advances are typically made as premiums come due, making one term loan payable on death of enough to fund all planned premiums can lock in the AFR on the entire loan for the insured's lifetime, as shown below.

Assumes a Female, age 55 and Standard Nonsmoker, Whole Life Policy from a Highly Rated Carrier, 33 Year LE, $50MM other estate assets growing at 3%. See full sample analysis downloadable below for additional details and assumptions.

1 Year	2 Annual Loan to Trust	3 Loan Receivable at 1.17% AFR Includible in Grantor-Insured's Taxable Estate	4 Annual Gift Taxes Payable by Grantor-Insured	5 Income Taxes Payable by Grantor-Insured on Trust Taxable Income	6 Grantor-Insured's Outlay	7 Annual Premiums Paid	8 Premium Reserve Assuming No Interest Earnings	9 Total Death Benefit	10 Columns 9 + 10 Less Estate & Income Tax on Loan Receivable	11 Income and Estate Tax Equiv-alent ROI on Column 6 & 10
1	7,000,000	**7,081,900**	-	-	**7,000,000**	1,000,000	6,000,000	19,908,819	**24,162,558**	551.46%
2	-	**7,164,758**	-	-	-	1,000,000	5,000,000	19,925,371	**23,149,942**	164.80%
3	-	**7,248,586**	-	-	-	1,000,000	4,000,000	19,952,477	**22,147,975**	91.63%
4	-	**7,333,394**	-	-	-	1,000,000	3,000,000	19,988,481	**21,154,042**	61.79%
5	-	**7,419,195**	-	-	-	1,000,000	2,000,000	20,013,707	**20,148,930**	45.64%
6	-	**7,506,000**	-	-	-	1,000,000	1,000,000	21,628,162	**20,161,712**	39.78%
7	-	**7,593,820**	-	-	-	1,000,000	-	24,174,730	**21,674,693**	35.36%
8	-	**7,682,668**	-	-	-	-	-	19,612,896	**17,079,067**	25.29%
10	-	**7,863,494**	-	-	-	-	-	20,448,916	**17,846,387**	20.63%
20	-	**8,833,505**	-	-	-	-	-	25,414,023	**22,440,203**	11.77%
33	**-**	**10,275,567**	**-**	**-**	**-**	**-**	**-**	**34,826,171**	**31,295,102**	**8.58%**
40	-	**11,147,258**	-	-	-	-	-	42,094,132	**38,224,154**	7.81%

Click here for the full sample analysis of the above illustration and here for the whole life policy illustration.

Below is an illustration of the benefit of reducing the amount subject to estate tax and increasing tax-equivalent ROI at LE that a lower AFR can have on loan regime split dollar based on the above policy values and assumptions.

	1.17% Long-Term AFR	2% Long-Term AFR	3% Long-Term AFR	4% Long-Term AFR	5% Long-Term AFR
One-Time Loan for All Planned Premiums	7,000,000	7,000,000	7,000,000	7,000,000	7,000,000
Accrued Loan at LE Subject to Estate Tax	**10,275,567**	**13,455,620**	**18,566,347**	**25,538,668**	**35,022,320**
Death Benefit Net of Estate Tax on Loan Receivable at LE	31,295,102	30,140,268	28,250,859	25,619,326	21,960,220
Income and Estate Tax-Equivalent ROI at LE	**8.58%**	**8.40%**	**8.10%**	**7.65%**	**6.94%**

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STRATEGY 1: INTRAFAMILY SPLIT DOLLAR LOAN ARRANGEMENT

ADDITIONAL POTENTIAL ADVANTAGES WHEN COMBINED WITH OTHER COMMON ESTATE PLANNING TECHNIQUES

- **Due to the avoidance of taxable gifts via accruing interest, the Grantor-Insured's Basic Exclusion Amount (BEA) can be allocated to gifts of other assets or preserved for other income tax basis or estate planning purposes.**

- **Because death benefit proceeds are not includible in the beneficiary's taxable income, life insurance is generally the only asset that receives a basis step-up outside one's taxable estate, making it an efficient asset to fund via gifts or loans, help offset capital gain tax exposure in other trust assets or provide estate tax liquidity.[7]**

- **Trustee can repay the split dollar loan low-basis trust property (previously transferred using Grantor-Insured's BEA, an installment sale, or otherwise) during life without recognizing taxable income on the gain, thus transferring it into the Grantor-Insured's taxable estate to receive a basis step-up at death and reduce post-mortem capital gain tax exposure for Beneficiaries.[8]**

RETURN TO TOPICS

DOWNLOAD STRATEGY 1 PDF

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ENDNOTES

[1] A split dollar loan is generally defined as any payment from the non-owner to the owner of the policy the repayment of which is to be made from, or secured by, the policy's cash value, death benefit or both and, if not treated as a loan under general Federal tax law principles, a reasonable person would expect such repayment to be made in full. See Treas. Reg. 1.7872-15.
[2] For the promissory note to be non-recourse the lender and borrower need to attest in writing that a reasonable person would expect the loan to be repaid in full and submit such representation with their tax returns for each taxable year in which a loan advance is made. If interest is paid or accrued at a rate less than the AFR, then the below-market loan rules will operate to impute transfers between the lender and borrower for income and gift tax purposes. The timing, amount and characterization of imputed transfers depend upon the relationship between the parties and whether the loan is a demand or term loan. See IRC § 7872 and Treas. Reg. 1.7872-15.
[3] Pledging a MEC as collateral is treated as a distribution, causing ordinary income recognition by the owner to the extent of the increase in gain each year the pledge is in effect. Under the grantor trust rules, the pledge should be disregarded and ignored for income tax purposes if between the grantor and the trust but policy disbursements from the carrier to the trust would be recognized. Proceeds received upon surrender, including any outstanding and unrepaid policy loans, would be taxable as ordinary income to the extent of gain. See IRC §§ 72, 7702A and Rev. Rul. 85-13.
[4] See IRC § 101.
[5] Assuming the policy never becomes a MEC and stays in force until death, withdrawals up to cost basis and any policy loans do not give rise to taxable income. See IRC §§ 72 and 7702A.
[6] See IRC §§ 1272-1274 and Rev. Rul. 85-13.
[7] See IRC § 101.
[8] See IRC See IRC § 1014 and Rev. Rul. 85-13.
[9] If property is to be transferred to a trust with no other assets in exchange for a note, a seed gift may be required for economic substance to minimize risk of the transaction being treated as a transfer with retained right to receive trust income for the purposes of IRC § 2036. The general rule of thumb is that which would result in 10% or more equity after the sale, or a gift equal to 1/9 the face amount of the note. See PLRs 9251004 and 9535026. Actual equity required may vary depending on collateral, liquidity, income to support debt payments and other factors. It's important for note to be properly structured as to be treated as debt and not equity to avoid it being treated as a taxable gift with estate tax consequences under IRC §§ 2036 and 2701-2702. Many practitioners suggest that the note's term be less than the seller's life expectancy and for payments to be made by the Trust. If interest is not charged at or above the AFR then the below market loan rules of IRC § 7872 and OID rules of IRC §§ 1272-1274 generally apply and will impute transfers between the seller and buyer for income and gift tax purposes.
[10] Third party qualified appraisers should be used and the valuation should be well documented. Many practitioners recommended to report the sale on a Form 709 Gift Tax Return to start the running of the state of limitations period.
[11] See Rev. Rul. 85-13. Note, if grantor trust status terminates during life, trust property subject to debt may give rise to recognition of gain by the grantor to the extent the trust's debt exceeds its basis in the property. See Treas. Reg. 1.1001-2(c) Ex. 5.
[12] See IRC § 671.
[13] See Rev. Rul. 2004-64. Also, under this Ruling, Grantor can be reimbursed for Trust income taxes paid at the Trustee's discretion but there must be no express or implied understanding that the Trustee will exercise this discretion in favor of Grantor.
[14] Term of the note generally needs to be less than the seller's life expectancy. A seed gift may be required if the trust does not already have enough assets. A common rule of thumb ratio is a gift equal to 1/9 the value of the promissory note.
[15] To be recognized in calculating the value of the taxable gift, the retained annuity must be treated as a Qualified Interest under IRC § 2702.
[16] It is generally advisable to report the transaction on a Form 709 Gift Tax Return to start the running of the statute of limitations period.
[17] The value includible in the Grantor's taxable estate under IRC § 2036(a) during the Annuity Period is that amount of the GRAT corpus necessary to yield the annual annuity payment to the Grantor assuming an investment yield equal to the § 7520 Rate at death without reducing or invading principal. This amount is calculated by dividing the annual annuity amount (adjusted for monthly payments) by the § 7520 Rate at death and is limited to the FMV of the GRAT corpus at death, if less.
[18] See IRC § 671.
[19] See Rev. Rul. 85-13.
[20] See Rev. Rul. 2004-64.
[21] The remainder beneficiary takes a basis in the remaining property received equal to the GRAT's basis immediately before the transfer.
[22] If GRAT property underperforms, Grantor could exercise a power of substation and swap underperforming property for that which may be expected to grow at a higher rate.
[23] See IRC § 2642(f) and Treas. Reg. 26.2632-1(c)(1).
[24] See Rev. Rul. 85-13, PLRs 9251004 and 9535026 and Tax Court cases, *Karmazin v. Comm'r, Woelbing v. Comm'r, Wandry v. Comm'r,* and *Nelson v. Comm'r.*
[25] See Treas. Reg. § 25.2702-3(b)(1)(ii)(A).
[26] The nuances of and considerations for self-cancelling installment notes are complicated and beyond the scope of this piece.
[27] See Treas. Reg. § 25.2702-3(b)(2).
[28] Defined value formula clauses, such as what was upheld by the Tax Court in Wandry v. Commissioner, T.C. Memo 2012-88 (2012), are often used to help minimize the risk unanticipated gift tax consequences arising from a revaluation of property transferred in exchange for a note. However, these clauses are still susceptible to challenge as is evident by Nelson v. Commissioner, T.C. Memo 2020-81 (2020), a recent case in which the Court ruled in favor of the IRS.
[29] See Walton v. Commissioner, 115 T.C. 589, 115 T.C. No. 41 (2000).
[30] See endnote 9.
[31] See endnote 17.
[32] See Treas. Reg. 20.2031-4 for guidance on the valuation of promissory notes for estate tax purposes.
[33] See IRC § 2642(f) and Treas. Reg. 26.2632-1(c)(1).
[34] See IRC § 2522(c)(2)(B).
[35] See Priv. Ltr. Rul. 200920031, Rev. Rul. 83-75 and Kenan v. Comm'r, 114 F2d 217, 25 AFTR 607 (2d Cir. 1940). The grantor could exercise a power of substitution to "swap" a low-basis CLAT asset with a high-basis personal one or cash that the CLAT could then use to make the annuity payment. However, this could be treated as an act of self-dealing under the private foundation rules applicable to CLATs. Giving such power to a non-adverse party trustee may preclude such treatment.
[36] It is generally advisable to report the transaction on a Form 709 Gift Tax Return to start the running of the statute of limitations period.
[37] See IRC § 170(f)(2)(B).
[38] See IRC § 671 and Rev. Rul. 85-13.
[39] See Rev. Rul. 2004-64. Note, it is possible that tax reimbursements to the Grantor by the Trustee could be treated as an act of self-dealing.
[40] See footnote 23 regarding the power to substitute property in response to underperforming property.
[41] See IRC § 2642(e).
[42] Increasing GRAT annuities are subject to a maximum increase over the prior year of 20%. See Treas. Reg. § 25.2702-3(b)(1)(ii)(A).

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