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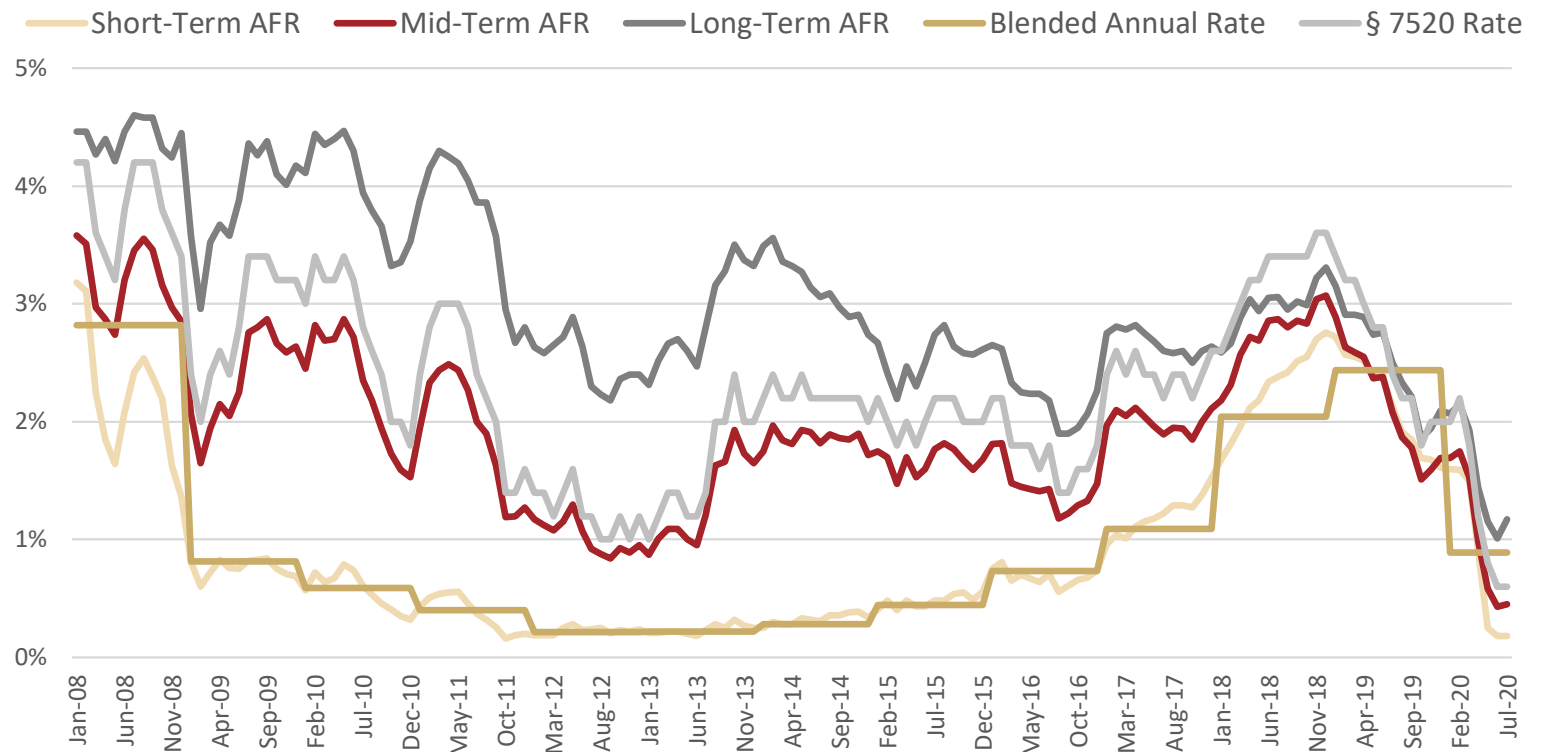
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**Interest Rates at Historic Lows,
Wealth Transfer Opportunities at
Historic Highs**

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%)			



Information herein is a simplified overview of complicated planning strategies. For discussion purposes only. Additional planning, tax and legal considerations apply. Individuals should seek guidance from a tax and legal practitioner regarding their circumstances.

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 survives 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.

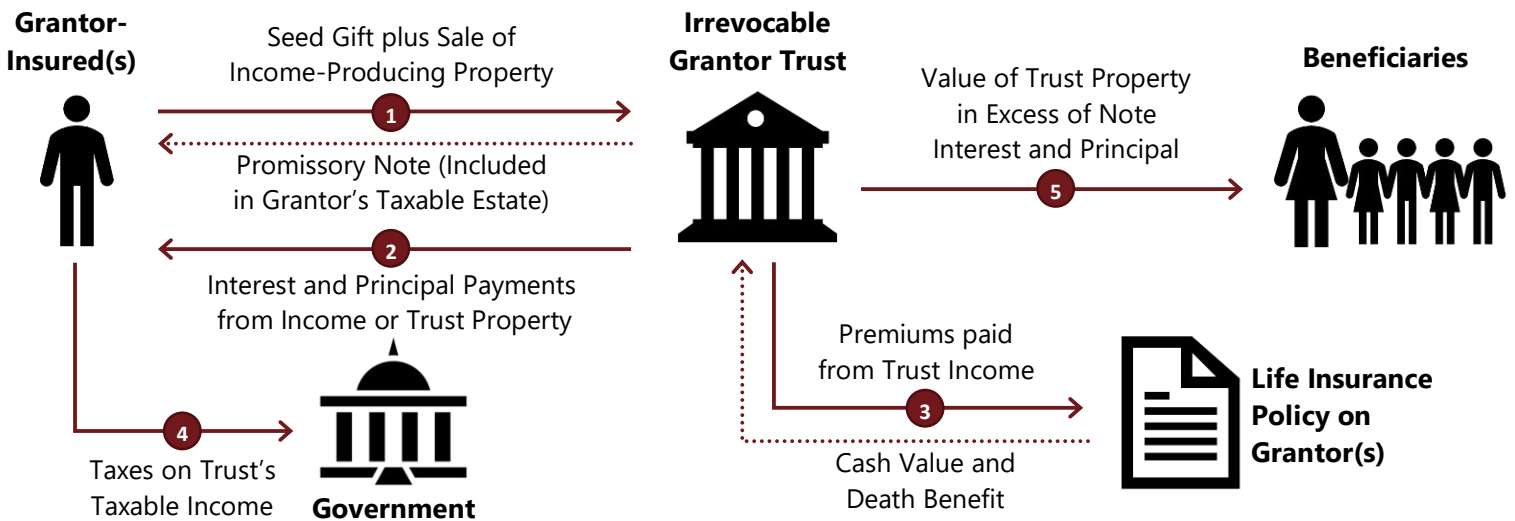
Leveraging the technique by freezing off a valuation discount can enhance the above techniques. If the FMV of the property gifted, loaned or sold can be legitimately discounted for gift tax purposes due to entity planning, economic recession and/or market volatility, the amount includible in the transferor’s 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.



STRATEGY 2 INSTALLMENT SALE TO AN IRREVOCABLE GRANTOR TRUST

HOW IT WORKS



- 1. Grantor-Insured makes a seed gift and then sells an interest in an asset or entity to the Trust as an installment obligation with an interest rate equal to the AFR for the note's term (0.18%, 0.45% or 1.17% for July 2020).⁹**

By selling minority, non-managing or fractional interests, valuation discounts may be applied in calculating the fair market value (FMV) of the property interests sold due to lack of marketability and control which can reduce the promissory note's face value and required interest payments, thus transferring additional discounted economic value.¹⁰

- 2. Interest is typically paid annually to the Grantor from the income produced by the asset or entity sold, or other Trust assets, with the balloon principal payment being made at the end of the note term.**

Payments can be made from Trust income or other property, including interests in the property sold. The grantor trust rules cause the transaction to be "disregarded" for income tax purposes and there is no income recognized by Grantor on the payments received whether in cash or appreciated property.¹¹ If valuation discounts are applied to the FMV of the property interests sold then any payments made with such property should reflect such discounts.

- 3. Trust income in excess of that needed to make note payments can be used to pay life insurance premiums.**

Life insurance can provide liquidity to help repay the note if Grantor-Insured dies during the term, pay estate taxes on the value of the note or other assets includible in his or her estate, or mitigate capital gain tax on post-death dispositions of Trust assets.

- 4. The Grantor is treated as the owner of Trust property for income tax purposes under the grantor trust rules and personally responsible for taxes payable on the Trust's taxable income.¹²**

Payment of the Trust's income taxes has the effect of an additional gift to the Trust but is not treated as such, which reduces the Grantor's taxable estate and allows more wealth to accrue to the Beneficiaries.¹³

- 5. Trust property appreciation and reinvested income in excess of note interest and principal payments can be shifted away from the Grantor's taxable estate and is transferrable to Trust Beneficiaries estate tax free.**

The value of the asset sold can be "frozen" in the Grantor's taxable estate for estate tax purposes at the face value of the promissory note plus the future value of payments received during the note term.



STRATEGY 2: INSTALLMENT SALE TO AN IRREVOCABLE GRANTOR TRUST

HOW IT BENEFITS FROM LOW INTEREST RATES

1. Locking in a low AFR for the note's term can reduce the amount of interest the Trustee must pay to the Grantor;
2. Create a lower wealth transfer "hurdle rate" allowing more Trust asset appreciation and reinvested income to be shifted outside the Grantor's taxable estate and transferrable to Beneficiaries estate tax free; and
3. Increase Trust income available to pay life insurance premium or reduce the corresponding sale amount required.

HYPOTHETICAL ILLUSTRATIVE EXAMPLES

Many installment sales for estate planning purposes are structured with a note term of nine years or less to use the mid-term AFR as compared to the long-term AFR, between which there had been a noticeable spread, and as interest-only with a balloon payment of principal upon maturity, as the below example illustrates.

Assumes 5% income and 2% growth, 37% Grantor marginal tax rate, no valuation discount for simplicity's sake and the following design parameters:

	1	2	3	4	5			
	\$9,000,000	9 Years	0.45%	\$1,000,000	\$10,000,000			
	Asset or Entity Sale	Promissory Note	Mid-Term AFR	Taxable Seed Gift	Total Asset Transfer			
Year	Trust Growth	Trust Income (Taxable to Grantor)	Interest Payments to Grantor at 0.45% AFR	Principal Payments in Kind to Grantor	Ending Trust Value	Note Receivable Subject to Estate Tax	Trust Equity Not Subject to Estate Tax	Grantor's Tax Due on Trust Income
1	200,000	500,000	-40,500	-	10,659,500	9,000,000	1,659,500	-185,000
2	213,190	532,975	-40,500	-	11,365,165	9,000,000	2,365,165	-197,201
3	227,303	568,258	-40,500	-	12,120,227	9,000,000	3,120,227	-210,256
4	242,405	606,011	-40,500	-	12,928,142	9,000,000	3,928,142	-224,224
5	258,563	646,407	-40,500	-	13,792,612	9,000,000	4,792,612	-239,171
6	275,852	689,631	-40,500	-	14,717,595	9,000,000	5,717,595	-255,163
7	294,352	735,880	-40,500	-	15,707,327	9,000,000	6,707,327	-272,276
8	314,147	785,366	-40,500	-	16,766,340	9,000,000	7,766,340	-290,586
9	335,327	838,317	-40,500	-9,000,000	8,899,484	-	8,899,484	-310,177
Total	2,361,138	5,902,845	-364,500	-9,000,000	8,899,484	-	8,899,484	-2,184,053

Click [here](#) for a sample of a more detailed analysis illustrating the economics of a 9-year installment sale with life insurance (a separate example, not reflecting the values above).

Installment sales can be used to help fund Trust-owned life insurance premiums with reduced taxable gift exposure. Below is an illustration of the increase in the affordable face amount per \$10MM of sale/gift amount (at 9/1 ratio) based on available Trust income in the first year at lower AFRs. See the example below.

Assumes a male age 55 and standard plus non-tobacco, solve for maximum guaranteed face amount to age 120 with a no-lapse guarantee policy paid up after 9 years, rounded to nearest 1,000, first premium paid from the seed gift.

Life Insurance Premium Funding:	0.45% Mid-Term AFR	1.00% Mid-Term AFR	2.00% Mid-Term AFR	3.00% Mid-Term AFR
Affordable Face Amount of Policy based on Initial Trust Income Available for Premium from a \$9MM Asset Sale + \$1MM Seed Gift	\$13,793,000	\$12,292,000	\$9,580,000	\$6,899,000



STRATEGY 2: INSTALLMENT SALE TO AN IRREVOCABLE GRANTOR TRUST

Due to the historically low long-term AFR, and small spread over the mid-term, it could be advantageous to structure Installment Sales for longer durations to lock in a very low wealth transfer hurdle rate for a longer period, allowing more long-term appreciation potential to be transferred away from the Grantor's taxable estate and gift tax free.¹⁴ See below.

Assumes 5% income and 2% growth, 37% Grantor marginal tax rate, no valuation discount for simplicity sake and the following design parameters:

1	2	3	4	5
\$9,000,000	20 Years	1.17%	\$1,000,000	\$10,000,000
Asset or Entity Sale	Promissory Note	Long-Term AFR	Taxable Seed Gift	Total Asset Transfer

Year	Trust Growth	Trust Income (Taxable to Grantor)	Interest Payments to Grantor at 1.17% AFR	Principal Payments to Grantor	Ending Trust Value	Note Receivable Subject to Estate Tax	Trust Equity Not Subject to Estate Tax	Grantor's Tax Due on Trust Income
1	200,000	500,000	-105,300	-	10,594,700	9,000,000	1,594,700	-185,000
2	211,894	529,735	-105,300	-	11,231,029	9,000,000	2,231,029	-196,002
3	224,621	561,551	-105,300	-	11,911,901	9,000,000	2,911,901	-207,774
5	252,809	632,022	-105,300	-	13,419,964	9,000,000	4,419,964	-233,848
10	342,466	856,165	-105,300	-	18,216,642	9,000,000	9,216,642	-316,781
15	468,216	1,170,539	-105,300	-	24,944,229	9,000,000	15,944,229	-433,099
20	644,585	1,611,464	-105,300	-9,000,000	25,380,019	-	25,380,019	-596,242
Total	7,567,434	18,918,585	-2,106,000	-9,000,000	25,380,019	-	25,380,019	-6,999,877

Click [here](#) for a sample of a more detailed analysis illustrating the economics of a 20-year installment sale with life insurance (a separate example, not reflecting the values above).

Below is another analysis of the affordable face amount per \$10MM of sale/gift amount (at 9/1 ratio) at various AFRs based on the available Trust income in the first year if used to fund Trust-owned life insurance premiums.

Assumes a male age 55 and standard plus non-tobacco, solve for maximum guaranteed face amount to age 120 with a no-lapse guarantee policy paid up after 20 years, rounded down to nearest 1,000, first premium paid from the seed gift.

Life Insurance Premium Funding:	1.17% Long-Term AFR	2.00% Long-Term AFR	3.00% Long-Term AFR	4.00% Long-Term AFR
Affordable Face Amount of Policy based on Trust Income Available for Premium from a \$9MM Asset Sale + \$1MM Seed Gift	\$19,301,000	\$15,608,000	\$11,242,000	\$6,825,000

ADDITIONAL POTENTIAL ADVANTAGES IN THE CURRENT ENVIRONMENT

- Many privately held business interests or income-producing assets may have experienced temporary declines in fair market value (FMV) due to the economic impact of the COVID-19 pandemic; and
- If such assets are expected to substantially rebound in value as the economy recovers over the next couple years, now may be an opportunistic time to consider selling such assets to a Trust using this technique; because
- The temporarily reduced FMV can help reduce the face value and payments owed by the Trust under an installment sale and subsequent growth can be shifted outside the Grantor's taxable estate, thus transferring significant amounts of wealth to Beneficiaries gift and estate tax free.

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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 substitution 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).



If you have any questions, please reach out to your financial professional.



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