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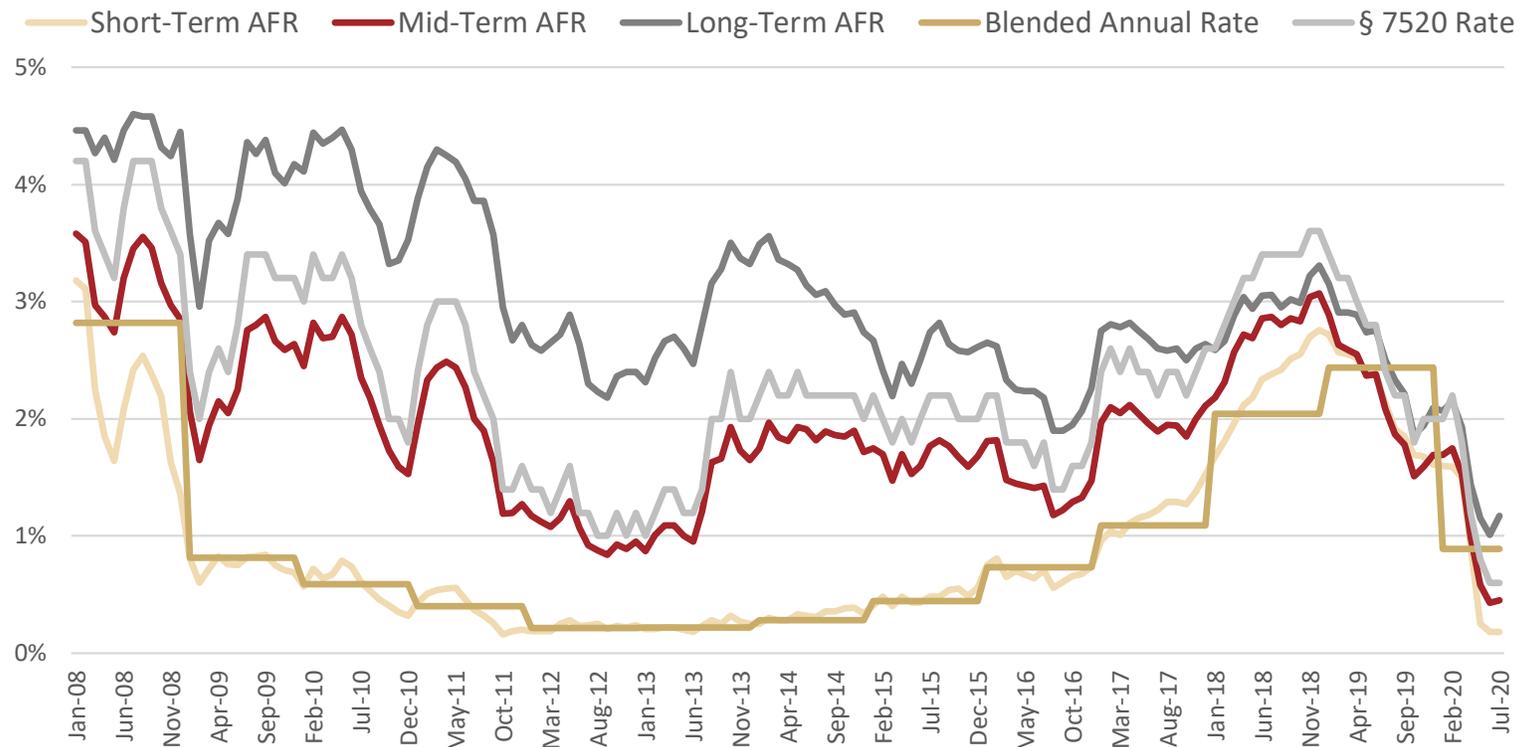
1089 West Morse Blvd., Ste. C  
Winter Park, Florida 32789

**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:

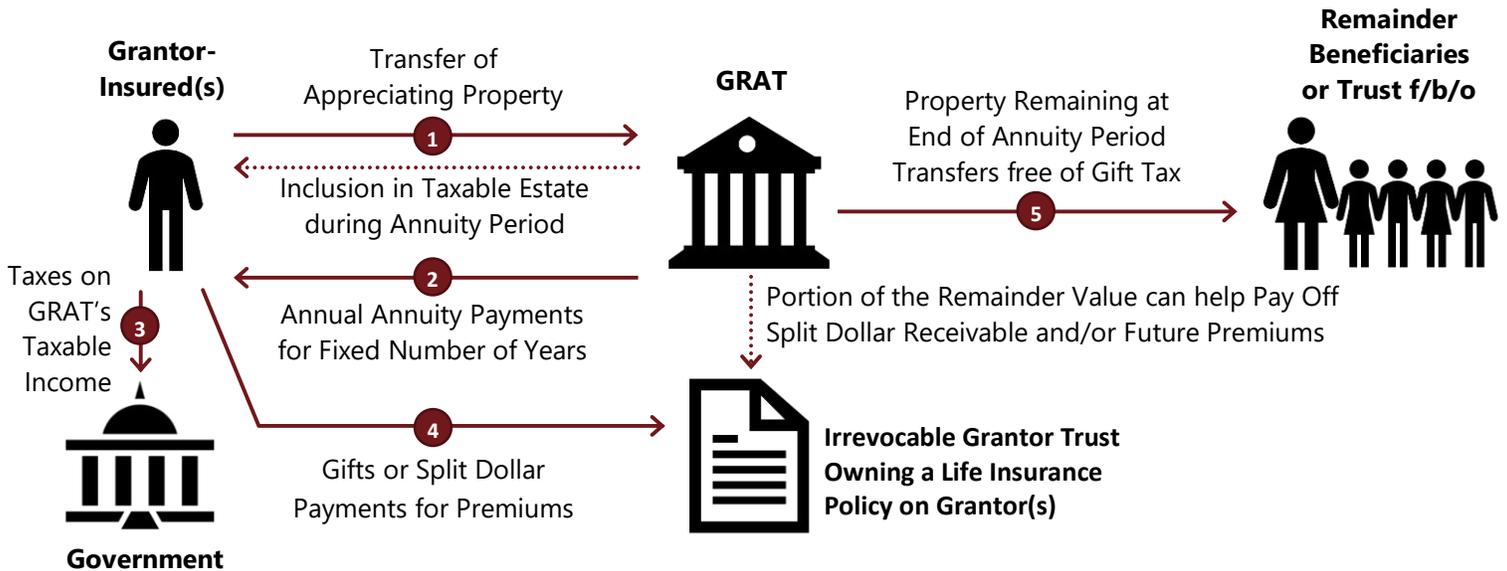
	Period of Compounding			
	Annual	Semi-Annual	Quarterly	Monthly
<b>Short-Term AFR</b> (Term loans not more than 3 years)	<b>0.18%</b>	<b>0.18%</b>	<b>0.18%</b>	<b>0.18%</b>
<b>Mid-Term AFR</b> (Term loans over 3, not more than 9 years)	<b>0.45%</b>	<b>0.45%</b>	<b>0.45%</b>	<b>0.45%</b>
<b>Long-Term AFR</b> (Over 9 years)	<b>1.17%</b>	<b>1.17%</b>	<b>1.17%</b>	<b>1.17%</b>
<b>2020 Blended Annual Rate</b> (Demand Loans)	<b>0.89%</b> (average of January and July Short-Term AFRs for the year)			
<b>§ 7520 Rate</b> (Present value of annuity, interest for life or term of years, or remainder or reversionary interest)	<b>0.6%</b> (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.

# STRATEGY 3 GRANTOR RETAINED ANNUITY TRUST (GRAT)

## HOW IT WORKS



### 1. Grantor-Insured transfers property that is expected to appreciate in value to the GRAT.

The FMV of property transferred less the present value (PV) of the qualified retained annuity interest in step 2, discounted at the § 7520 Rate (0.6% for July 2020), equals the taxable gift to the Remainder Beneficiaries at inception.<sup>15</sup>

### 2. Grantor-Insured receives a fixed annual annuity payment for a fixed number of years ("Annuity Period").

Payments can be made from GRAT income or principal including in-kind property interests. If valuation discounts are applied to the FMV of property gifted, any distribution of such property should reflect such discounts. Annuity interest can be set so its PV is equal to the FMV of property transferred to minimize the taxable gift.<sup>16</sup> A portion of or all the GRAT property is includible in the Grantor's taxable estate, subject to estate tax, if death occurs during the Annuity Period.<sup>17</sup>

### 3. The Grantor is treated as the owner of GRAT property for income tax purposes under the grantor trust rules and personally responsible for taxes payable on the Trust's taxable income.<sup>18</sup>

Transactions between the Grantor and GRAT are disregarded for income tax purposes, thus the Grantor does not recognize income on the Annuity payments received nor on GRAT payments made with appreciated property.<sup>19</sup> Payment of the GRAT's income taxes has the effect of an additional gift to the GRAT but is not treated as such, which reduces the Grantor's taxable estate and allows more wealth to accrue to the Beneficiaries.<sup>20</sup>

### 4. To help pay estate taxes on GRAT property includible in the Grantor's taxable estate during the Annuity Period, the Grantor can set up another Trust to own Life Insurance and make gifts or split dollar loans to pay premiums.

At a minimum, a term policy insuring the Grantor with a term at least as long as the GRAT Annuity Period should be acquired but a strong case can be made for a permanent policy extending beyond this period as illustrated below.

### 5. GRAT property remaining at the end of the Annuity Period is transferred to Remainder Beneficiaries gift tax free.<sup>21</sup>

The value of the transfer to the GRAT is "frozen" in the Grantor's taxable estate for estate tax purposes at a value equal to the taxable gift at inception plus the future value of annuity payments received. For a GRAT to be successful in transferring wealth, property contributed must appreciate at a rate higher than the § 7520 Rate throughout the Annuity Period.<sup>22</sup> A portion of the remainder value can be transferred to the Life Insurance Trust to repay split dollar receivable owed to the Grantor-Insured(s) or pay future premiums, if applicable. Grantor's GST Exemption can be allocated to the value of GRAT property at the end of the Annuity Period but not sooner which can make GST planning with GRATs challenging.<sup>23</sup>



## STRATEGY 3: GRANTOR RETAINED ANNUITY TRUST (GRAT)

## HOW IT BENEFITS FROM LOW INTEREST RATES

1. A low § 7520 Rate results in a higher present value of the annuity interest, which helps reduce the taxable gift or the annuity payment required to achieve a specific taxable gift; and
2. Creates a lower wealth transfer “hurdle rate” allowing more appreciation and reinvested income from GRAT property to be transferred to Remainder Beneficiaries gift tax free.

## HYPOTHETICAL ILLUSTRATIVE EXAMPLES

Many GRATs are designed with shorter annuity periods, e.g. 2-10 years, to minimize the risk of inclusion in the Grantor's taxable estate, capitalize on shorter-term growth expectations for estate planning purposes and mitigate longer-term economic risk and uncertainty. The annuity amount is typically set so its PV is approximately equal to the property transferred to “zero out” the taxable gift and neutralize the risk depreciation over the annuity period. 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	6
<b>\$10,000,000</b>	<b>0.6%</b>	<b>9-Year</b>	<b>\$1,144,596</b>	<b>\$9,999,000</b>	<b>\$1,000</b>
FMV of Property Contributed	§ 7520 Rate at Inception	Annuity Period	Annuity Amount	Present Value of the Annuity	Taxable Gift (1 minus 5)

Year	GRAT Growth	GRAT Income (Taxable to Grantor)	GRAT Annuity Payment Made from Income	GRAT Annuity Payment Made in Kind	Total GRAT Annuity Payment to Grantor	GRAT Remainder Value	Grantor's Tax Due on GRAT Income
1	200,000	500,000	-500,000	-644,596	-1,144,596	9,555,404	-185,000
2	191,108	477,770	-477,770	-666,826	-1,144,596	9,079,687	-176,775
3	181,594	453,984	-453,984	-690,611	-1,144,596	8,570,669	-167,974
4	171,413	428,533	-428,533	-716,062	-1,144,596	8,026,020	-158,557
5	160,520	401,301	-401,301	-743,295	-1,144,596	7,443,245	-148,481
6	148,865	372,162	-372,162	-772,434	-1,144,596	6,819,677	-137,700
7	136,394	340,984	-340,984	-803,612	-1,144,596	6,152,458	-126,164
8	123,049	307,623	-307,623	-836,973	-1,144,596	5,438,535	-113,820
9	108,771	271,927	-271,927	-872,669	-1,144,596	4,674,636	-100,613
<b>Total</b>	<b>1,421,714</b>	<b>3,554,285</b>	<b>-3,554,285</b>	<b>-6,747,078</b>	<b>-10,301,362</b>	<b>4,674,636</b>	<b>-1,315,085</b>

Click [here](#) for a sample analysis illustrating a 9-GRAT the remainder value of which funds a Life Insurance Trust.

Below is an analysis of the positive effect that a lower § 7520 Rate can have on GRATs for wealth transfer purposes when targeting the same taxable gift amount at inception and using the same assumptions as above.

	0.6% § 7520 Rate	2% § 7520 Rate	3% § 7520 Rate	4% § 7520 Rate	5% § 7520 Rate	6% § 7520 Rate	7% § 7520 Rate
<b>FMV of Property Contributed</b>	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000
<b>9-Year Annuity</b>	<b>1,144,596</b>	<b>1,225,032</b>	<b>1,284,210</b>	<b>1,344,795</b>	<b>1,406,760</b>	<b>1,470,075</b>	<b>1,534,711</b>
<b>PV of Annuity</b>	9,999,000	9,999,000	9,999,000	9,999,000	9,999,000	9,999,000	9,999,000
<b>Taxable Gift</b>	1,000	1,000	1,000	1,000	1,000	1,000	1,000
<b>Remainder Value</b>	<b>4,674,636</b>	<b>3,711,174</b>	<b>3,002,338</b>	<b>2,276,648</b>	<b>1,534,435</b>	<b>776,046</b>	<b>1,838</b>



## STRATEGY 3: GRANTOR RETAINED ANNUITY TRUST (GRAT)

Due to the historically low § 7520 Rate, it could be advantageous to structure GRATs for longer 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 if he or she survives the GRAT Annuity Period, as illustrated 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	6
	<b>\$10,000,000</b> FMV of Property Contributed	<b>0.6%</b> § 7520 Rate at Inception	<b>20 Years</b> Annuity Period	<b>\$532,043</b> Annuity Amount	<b>\$9,999,000</b> Present Value of the Annuity	<b>\$1,000</b> Taxable Gift (1 minus 5)

Year	GRAT Growth	GRAT Income (Taxable to Grantor)	GRAT Annuity Payment Made from Income	GRAT Annuity Payment Made in Kind	Total GRAT Annuity Payment to Grantor	GRAT Remainder Value	Grantor's Tax Due on GRAT Income
1	200,000	500,000	-500,000	-32,043	-532,043	10,167,957	-185,000
2	203,359	508,398	-508,398	-23,646	-532,043	10,347,670	-188,107
3	206,953	517,384	-517,384	-14,660	-532,043	10,539,964	-191,432
5	214,914	537,286	-532,043	0	-532,043	10,965,875	-198,796
10	240,236	600,589	-532,043	0	-532,043	12,320,564	-222,218
15	275,750	689,375	-532,043	0	-532,043	14,220,586	-255,069
20	325,561	813,902	-532,043	0	-532,043	16,885,465	-301,144
<b>Total</b>	<b>5,007,524</b>	<b>12,518,809</b>	<b>-10,565,473</b>	<b>-75,394</b>	<b>-10,640,867</b>	<b>16,885,465</b>	<b>-4,631,959</b>

Click [here](#) for a sample analysis illustrating a 20-GRAT the remainder value of which funds a Life Insurance Trust.

Below is another example of the positive effect that a lower § 7520 Rate can have on GRATs for wealth transfer when targeting the same taxable gift amount at inception and using the same 20-year GRAT assumptions above.

	<b>0.6%</b> § 7520 Rate	<b>2%</b> § 7520 Rate	<b>3%</b> § 7520 Rate	<b>4%</b> § 7520 Rate	<b>5%</b> § 7520 Rate	<b>6%</b> § 7520 Rate	<b>7%</b> § 7520 Rate
<b>FMV of Property Contributed</b>	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000
<b>20-Year Annuity</b>	<b>532,043</b>	<b>611,506</b>	<b>672,090</b>	<b>735,744</b>	<b>802,346</b>	<b>871,758</b>	<b>943,835</b>
<b>PV of Annuity</b>	9,999,000	9,999,000	9,999,000	9,999,000	9,999,000	9,999,000	9,999,000
<b>Taxable Gift</b>	1,000	1,000	1,000	1,000	1,000	1,000	1,000
<b>Remainder Value</b>	<b>16,885,465</b>	<b>13,627,854</b>	<b>11,144,190</b>	<b>8,534,660</b>	<b>5,804,291</b>	<b>2,958,680</b>	<b>3,870</b>

A longer duration GRAT can potentially transfer more wealth gift tax free but causes more inclusion risk of its property being subject to estate tax due to a longer Annuity Period during which Grantor may die. However, depending on the annuity amount and § 7520 Rate at death, the portion of GRAT property subject to estate tax may be less than 100%:

	<b>0.6%</b> § 7520 Rate at Death	<b>2%</b> § 7520 Rate at Death	<b>3%</b> § 7520 Rate at Death	<b>4%</b> § 7520 Rate at Death	<b>5%</b> § 7520 Rate at Death	<b>6%</b> § 7520 Rate at Death	<b>7%</b> § 7520 Rate at Death
<b>Maximum Amount Includible in Estate</b> \$532,043 Annuity ÷ § 7520 Rate at Death	<b>88,673,833</b> or FMV of GRAT property if less	<b>26,602,150</b> or FMV of GRAT property if less	<b>17,734,767</b> or FMV of GRAT property if less	<b>13,301,075</b> or FMV of GRAT property if less	<b>10,640,860</b> or FMV of GRAT property if less	<b>8,867,383</b> or FMV of GRAT property if less	<b>7,600,614</b> or FMV of GRAT property if less



## STRATEGY 3: GRANTOR RETAINED ANNUITY TRUST (GRAT)

# THE CASE FOR PERMANENT LIFE INSURANCE NOTWITHSTANDING A TEMPORARY NEED SPECIFIC TO A GRAT

Life Insurance can help provide liquidity for estate taxes on GRAT property if the Grantor dies during the Annuity Period. If Permanent Life Insurance is not otherwise being considered, Term Life Insurance is often purchased, which may expire before death since most Term policies generally do not pay a death claim, either due to the insured outliving the term, converting the policy to permanent, or otherwise.

Permanent Life Insurance may provide more long-term value and flexibility than Term, such as liquidity for estate taxes on other estate property, protection to compliment future “bet to live” estate planning techniques, mitigation of capital gain tax on post-mortem dispositions by a Trust or Beneficiary, cash value accumulation that can provide a line of credit during life, the ability to monetize the policy by selling it in the secondary market if it is no longer needed, and more.

In addition to these potential planning benefits, a strong case can be made by analyzing the “incremental” internal rate of return (IRR) on premiums paid at death. Since the Term policy’s temporary coverage may be required, regardless, to hedge the inherent GRAT mortality risk, it can be viewed as a “sunk cost” and this portion of the premium and death benefit can be disregarded in calculating the IRR on the cost and benefit of a Permanent policy as illustrated below.

In other words, since the Term cost will be incurred regardless, what is the long-term IRR on the additional (incremental) cost and benefit of a Permanent policy the client would pay and receive? The below example demonstrates this potentially attractive long-term benefit after the Term policy expires expressed as an incremental IRR at death.

*Assumes a female, age 55, standard plus non-tobacco, 33-year LE, best 20-year level term policy vs. no-lapse guarantee permanent policy to age 100 with return of premium death benefit, 25% average income tax rate for tax-equivalent calculation.*

1	“Sunk Cost” Term Policy			Permanent Policy Incremental Analysis					
	2	3	4	5	6	7	8	9	10
Year	Guaranteed Premium	Guaranteed Death Benefit	Income Tax-Equivalent IRR at Death <i>On 2 and 3</i>	Guaranteed Premium	Guaranteed Death Benefit with Return of Premium	Income Tax-Equivalent IRR on Death Benefit	Incremental Guaranteed Premium <i>5 minus 2</i>	Incremental Guaranteed Death Benefit <i>6 minus 3</i>	Incremental Income Tax-Equivalent IRR at Death <i>On 8 and 9</i>
1	27,342	10,000,000	48631.9%	143,705	10,143,705	9,278.3%	116,363	143,705	31.3%
3	27,342	10,000,000	771.8%	143,705	10,431,716	372.0%	116,363	431,116	14.6%
5	27,342	10,000,000	267.3%	143,705	10,718,527	145.4%	116,363	718,527	9.5%
10	27,342	10,000,000	85.9%	143,705	11,437,054	48.5%	116,363	1,437,054	5.1%
20	27,342	10,000,000	31.7%	143,705	12,874,109	17.1%	116,363	2,874,109	2.6%
21	Policy Lapses		-100.0%	143,705	13,017,814	15.9%	143,705	13,017,814	18.0%
30			-100.0%	143,705	14,311,163	9.2%	143,705	14,311,163	10.5%
33	Life Expectancy		-100.0%	143,705	14,742,279	8.0%	143,705	14,742,279	9.1%
35			-100.0%	143,705	15,029,690	7.3%	143,705	15,029,690	8.3%
40			-100.0%	143,705	15,748,217	5.9%	143,705	15,748,217	6.7%

## 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 gifting assets to a GRAT; because
- The temporarily reduced FMV can help reduce the annuity payments necessary to zero out the taxable gift and subsequent growth can be shifted outside the Grantor’s taxable estate and transferred to Beneficiaries gift and estate tax free at the end of the Annuity Period.



## STRATEGY 3: GRANTOR RETAINED ANNUITY TRUST (GRAT)

# COMPARISON – GRANTOR RETAINED ANNUITY TRUST VS. INSTALLMENT SALE TO IRREVOCABLE GRANTOR TRUST

A common question is when is a GRAT ideal vs. an Installment Sale and vice versa? As with many techniques, neither is always better, rather they are different with contrasting planning purposes or applications based on individual priorities and circumstances. Below is a high-level, non-exhaustive list of some of the key pros and cons of each. Note, the technicalities of these strategies can be quite complicated and are beyond the scope of this piece.

	<b>Grantor Retained Annuity Trust</b>	<b>Installment Sale to Irrevocable Grantor Trust</b>	<b>Advantage Generally Goes To</b>
<b>Tax and Legal Authority</b>	Statutory authority and safe harbors codified by IRC § 2702 and regulations thereunder	Primary guidance from Revenue Rulings and Letter Rulings, which do not carry the force of law and are not binding on a court, and court cases; possibly more susceptible to challenge <sup>24</sup>	<b>GRAT</b>
<b>Wealth Transfer Hurdle Rate</b>	§ 7520 Rate (120% of the Mid-Term AFR rounded to nearest 0.20%; 0.60% for June 2020)	Short-, Mid- or Long-Term AFR based on note's term (0.18%, 0.45% or 1.17% for July 2020)	<b>&lt; 9 Year Term = Installment Sale &gt; 9 Year Term = GRAT</b>
<b>Payment Structure and Flexibility</b>	Fixed annuity payments amortized over the Term (maximum annual increase of 20% over prior year <sup>25</sup> )	Can be amortized, interest-only with a balloon payment or somewhere in between (as well as self-canceling at death if structured properly <sup>26</sup> )	<b>Installment Sale</b>
<b>Valuation Considerations</b>	If the valuation of property transferred to the GRAT is redetermined due to a gift tax audit, the GRAT annuity payments automatically adjust accordingly to minimize unexpected gift tax consequences <sup>27</sup>	If the valuation of property sold is redetermined due to audit to be more than the consideration paid by the Trust, or if the note is treated as equity instead of debt, a portion or all the sale amount could be treated as a taxable gift with potential gift or estate tax consequences <sup>28</sup>	<b>GRAT</b>
<b>Gift Tax Considerations for Transfers to the Trust</b>	The value of the taxable gift can be zeroed out and is not subject to a minimum amount <sup>29</sup>	Generally, Grantor must make a minimum taxable gift so that enough Trust equity exists in excess of the note; general rule of thumb is 10% equity or 1/9 the value of the note <sup>30</sup>	<b>GRAT (assuming sufficient trust equity does not exist, otherwise neutral)</b>
<b>Estate Tax Considerations if Grantor Dies Prior to Termination</b>	All or a portion of GRAT property is includible in the Grantor's taxable estate often exceeding the initial transfer depending on the design and § 7520 Rate at death relative to inception <sup>31</sup>	Only the FMV of the promissory note is generally includible in the Grantor's taxable estate (unless the note is self-canceling) <sup>32</sup>	<b>Longer term and § 7520 Rate rose since inception, possibly = GRAT  Otherwise, typically = Installment Sale</b>
<b>GST Exemption Allocation</b>	GST Exemption can only be allocated to GRAT property at the end of the Annuity Period based on remaining GRAT value and available Exemption <sup>33</sup>	GST Exemption can be allocated to any taxable gifts made to the Trust at or after its creation	<b>Installment Sale</b>

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## ENDNOTES

<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> 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.

<sup>4</sup> See IRC § 101.

<sup>5</sup> 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.

<sup>6</sup> See IRC §§ 1272-1274 and Rev. Rul. 85-13.

<sup>7</sup> See IRC § 101.

<sup>8</sup> See IRC See IRC § 1014 and Rev. Rul. 85-13.

<sup>9</sup> 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.

<sup>10</sup> 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.

<sup>11</sup> 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.

<sup>12</sup> See IRC § 671.

<sup>13</sup> 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.

<sup>14</sup> 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.

<sup>15</sup> To be recognized in calculating the value of the taxable gift, the retained annuity must be treated as a Qualified Interest under IRC § 2702.

<sup>16</sup> 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.

<sup>17</sup> 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.

<sup>18</sup> See IRC § 671.

<sup>19</sup> See Rev. Rul. 85-13.

<sup>20</sup> See Rev. Rul. 2004-64.

<sup>21</sup> The remainder beneficiary takes a basis in the remaining property received equal to the GRAT's basis immediately before the transfer.

<sup>22</sup> 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.

<sup>23</sup> See IRC § 2642(f) and Treas. Reg. 26.2632-1(c)(1).

<sup>24</sup> 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*.

<sup>25</sup> See Treas. Reg. § 25.2702-3(b)(1)(ii)(A).

<sup>26</sup> The nuances of and considerations for self-cancelling installment notes are complicated and beyond the scope of this piece.

<sup>27</sup> See Treas. Reg. § 25.2702-3(b)(2).

<sup>28</sup> 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.

<sup>29</sup> See *Walton v. Commissioner*, 115 T.C. 589, 115 T.C. No. 41 (2000).

<sup>30</sup> See endnote 9.

<sup>31</sup> See endnote 17.

<sup>32</sup> See Treas. Reg. 20.2031-4 for guidance on the valuation of promissory notes for estate tax purposes.

<sup>33</sup> See IRC § 2642(f) and Treas. Reg. 26.2632-1(c)(1).

<sup>34</sup> See IRC § 2522(c)(2)(B).

<sup>35</sup> 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.

<sup>36</sup> 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.

<sup>37</sup> See IRC § 170(f)(2)(B).

<sup>38</sup> See IRC § 671 and Rev. Rul. 85-13.

<sup>39</sup> 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.

<sup>40</sup> See footnote 23 regarding the power to substitute property in response to underperforming property.

<sup>41</sup> See IRC § 2642(e).

<sup>42</sup> 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.**



515 Congress Ave., 25th Floor - Suite 2500 | Austin, TX 78701 | (512) 776-8400

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