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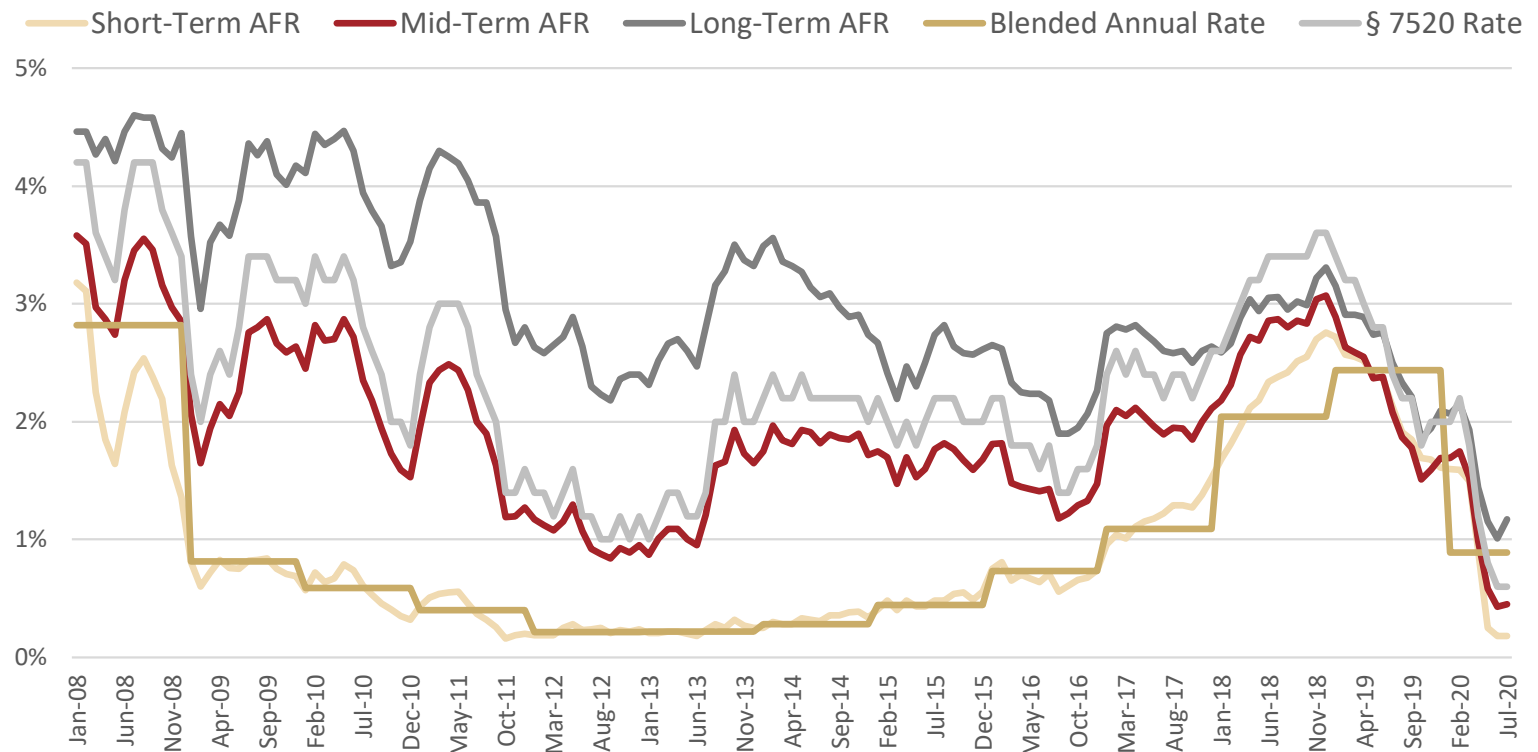
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**Interest Rates at Historic Lows,
Wealth Transfer Opportunities at
Historic Highs**

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:

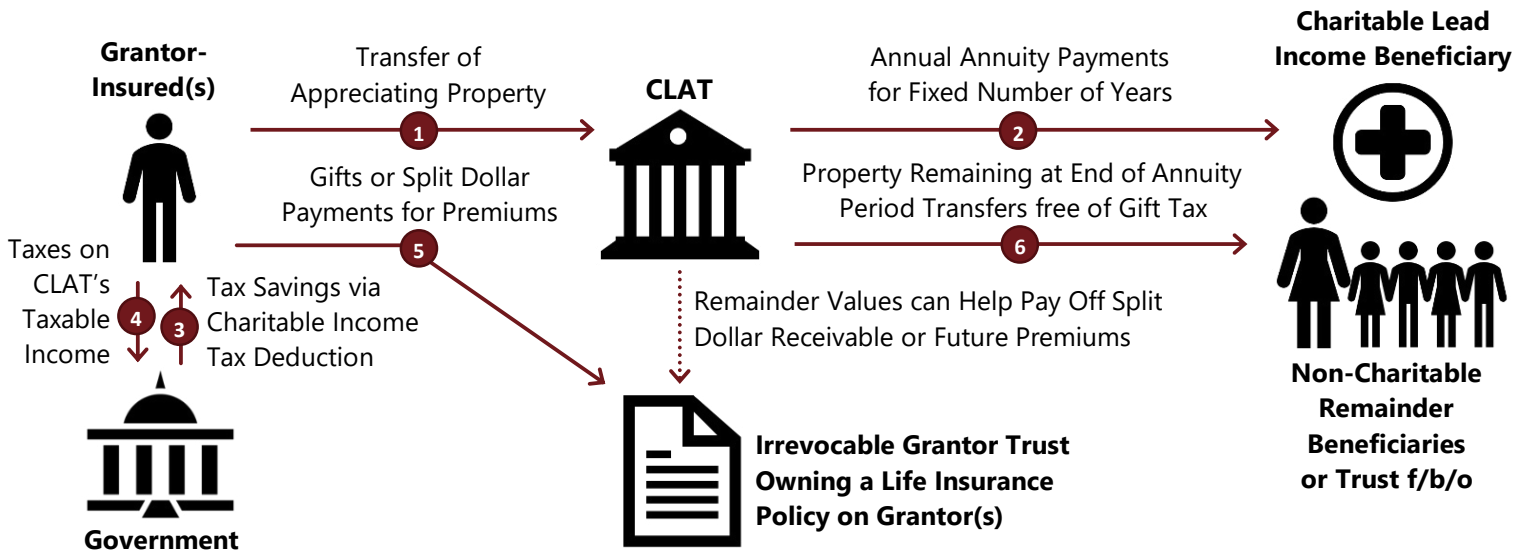
	Period of Compounding			
	Annual	Semi-Annual	Quarterly	Monthly
Short-Term AFR (Term loans not more than 3 years)	0.18%	0.18%	0.18%	0.18%
Mid-Term AFR (Term loans over 3, not more than 9 years)	0.45%	0.45%	0.45%	0.45%
Long-Term AFR (Over 9 years)	1.17%	1.17%	1.17%	1.17%
2020 Blended Annual Rate (Demand 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.

STRATEGY 4 CHARITABLE LEAD ANNUITY TRUST (CLAT)

HOW IT WORKS



1. Grantor-Insured gifts property that is expected to appreciate in value to the CLAT.

The PV of the lead annuity interest in step 2, discounted at the § 7520 Rate (0.6% for July 2020), can be eligible for the charitable gift tax deduction.³⁴ The FMV of property gifted less this amount equals the taxable gift to Remainder Beneficiaries.

2. Charitable Beneficiary receives fixed annual annuity payment for a fixed number of years ("Annuity Period").

Payments can be made from CLAT income or principal. Distributions of appreciated property in payment of the annuity may result in recognition of gain on such property.³⁵ If valuation discounts are applied to the FMV of property gifted, distributions of such property should reflect such discounts. The annuity interest can be set so its PV is equal to the FMV of property gifted to minimize the taxable gift to remainder Beneficiary and maximize the charitable income tax deduction to Grantor at inception.³⁶

3. Grantor-Insured can claim a charitable income tax deduction equal to the PV of the lead annuity interest.

To be eligible for the charitable income tax deduction, the CLAT must be a grantor trust with the Grantor being treated as the owner of Trust property for income tax purposes.³⁷ Because a gift to a CLAT is considered "for the use of" the charitable beneficiary, the amount of the deduction is limited to 30% or 20% of the Grantor's adjusted gross income (AGI), depending on the type of charitable beneficiary and property gifted, with any unusable amount carried forward for up to five years.

4. The Grantor is treated as the owner of CLAT property for income tax purposes under the grantor trust rules and personally responsible for taxes payable on the Trust's taxable income.³⁸

Payment of the CLAT's income taxes has the effect of an additional gift to the CLAT but is not treated as such, which reduces the Grantor's taxable estate and allows more wealth to accrue to the Remainder Beneficiaries.³⁹

5. To help pay estate taxes on other assets, replace wealth distributed to a charity or satisfy other needs, the Grantor can set up another Trust to own Life Insurance and make gifts or split dollar loans to pay premiums.

6. CLAT property remaining at the end of the Annuity Period is transferred to remainder Beneficiaries gift tax free.

For a CLAT to be successful in transferring wealth, property gifted must appreciate at a rate higher than the § 7520 Rate over the Annuity Period.⁴⁰ A portion of the remainder value can be transferred to the Life Insurance Trust to repay split dollar receivables owed to the Grantor-Insured(s) or pay future premiums, if applicable. Grantor's GST Exemption can be allocated at inception but the GST inclusion ratio is not determined until the end of the Annuity Period based on the value of CLAT property then and inflation adjustments over that time to the allocated Exemption amount at a rate equal to the initial § 7520 Rate; this can obfuscate GST planning.⁴¹



STRATEGY 4: CHARITABLE LEAD ANNUITY TRUST (CLAT)

HOW IT BENEFITS FROM LOW INTEREST RATES

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

HYPOTHETICAL ILLUSTRATIVE EXAMPLES

CLATs are often designed so that the annuity interest PV is roughly equal to the FMV of property contributed to maximize the charitable deduction and “zero out” the taxable gift or taxable income used to fund the transfer. Because eligibility for the income tax deduction depends on it being a grantor trust for income tax purposes, CLATs may seek to invest in tax-efficient (e.g. long-term capital gain or tax-exempt) assets to help minimize Grantor’s income tax liability and achieve an efficient tradeoff of ongoing tax liability on CLAT taxable income for the upfront deduction. See below.

Assumes gift of cash invested in publicly traded stocks, 5% growth and 2% dividend, 20% capital gain tax rate, 3.8% net investment income tax rate, 33% average tax rate for potential income tax savings, and the following design parameters:

1	2	3	4	5	6	7	8
\$10,000,000 FMV of Property Contributed	\$10,000,000 Cost Basis of Property Contributed	0.6% § 7520 Rate at Inception	20 Years Lead Annuity Period	\$532,043 Lead Annuity Amount	\$9,999,000 Annuity PV Value & Potential Charitable Deduction	\$1,000 Taxable Gift (1 minus 6)	\$3,333,000 Potential Income Tax Savings (6 x 33%)

Year	CLAT Growth	CLAT Dividend Income	Charitable Annuity Payment	CLAT Remainder Value	Portion of Payment Made from Dividend Income	Portion of Payment Made from Deemed Sale of Property	Realized Capital Gain on Deemed Sale of Property	Grantor's Tax Due on CLAT Taxable Income
1	500,000	200,000	-532,043	10,167,957	-200,000	-332,043	15,812	-51,363
5	537,286	214,914	-532,043	10,965,875	-214,914	-317,129	68,650	-67,488
10	600,589	240,236	-532,043	12,320,564	-240,236	-291,808	112,663	-83,990
15	689,375	275,750	-532,043	14,220,586	-275,750	-256,293	133,012	-97,285
20	813,902	325,561	-532,043	16,885,465	-325,561	-206,482	128,661	-108,105
Total	12,518,809	5,007,524	-10,640,867	16,885,465	-5,007,524	-5,633,344	1,997,298	-1,667,147

Click [here](#) to download the detailed analysis of the above values.

The below analysis shows the total charitable income tax deduction that Grantor can claim with a five-year carry-forward based on various levels of current AGI using the assumptions and values above and a 30% AGI limit, a 2% AGI inflation rate and no other charitable gifts made during the 6-year period:

	\$1,000,000 Current AGI	\$2,000,000 Current AGI	\$3,000,000 Current AGI	\$4,000,000 Current AGI	\$5,000,000 Current AGI	\$6,000,000 Current AGI
Total Deduction Claimed over 6 Years	1,957,180	3,849,616	5,742,052	7,634,489	9,526,925	9,999,000
Unused Deduction Lost after 6 Years	8,041,820	6,149,384	4,256,948	2,364,511	472,075	0
Total Income Tax Savings over 6 Years	652,393	1,283,205	1,914,017	2,544,830	3,175,642	3,333,000

As shown, from an income tax perspective, CLATs can be more efficient for Grantors with higher AGI relative to the value of the charitable gift. Moreover, ideally, the higher the average income tax rate on AGI that is reduced by the deduction relative to the marginal tax rate attributable to the CLAT’s taxable income, the more efficient the income tax tradeoffs. However, even if the taxes paid by the Grantor on the CLAT’s taxable income outweigh the income tax savings on the deduction, the technique can still be effective because such payment of the CLAT’s income taxes helps inflate the ultimate value to the Remainder Beneficiaries and is not treated as a taxable gift by the Grantor.



STRATEGY 4: CHARITABLE LEAD ANNUITY TRUST (CLAT)

CLATs can benefit from low interest rates in similar ways as GRATs for wealth transfer. Moreover, a lower annuity payment from a lower § 7520 Rate can help reduce the need to distribute appreciated property to satisfy the payment, reducing the Grantor's income tax liability on any deemed sale of property. Below is an analysis of the positive effect that a lower § 7520 Rate can have on CLATs for wealth transfer and income taxes when targeting the same taxable gift amount and charitable income tax deduction at inception 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
FMV and Basis of Property Contributed	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000	10,000,000
20-Year Annuity	532,043	611,506	672,090	735,744	802,346	871,758	943,835
Annuity PV and Charitable Income Tax Deduction	9,999,000	9,999,000	9,999,000	9,999,000	9,999,000	9,999,000	9,999,000
Taxable Gift	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Remainder Value	16,885,465	13,627,854	11,144,190	8,534,660	5,804,291	2,958,680	3,870
Grantor's Total Tax Due on CLAT Taxable Income	1,667,147	1,753,183	1,818,778	1,887,698	1,959,808	2,034,963	2,113,001

Structuring the annuity to increase annually can result in a lower payment in the early years and higher payment in the later years compared to a level annuity. Such design can help maximize the remainder value by allowing more trust property to be invested early on, increasing overall potential for investment gains over the CLAT term. It can also reduce the need to distribute appreciated property to satisfy the payments in the early years which can reduce the Grantor's initial income tax liability on deemed sale of property and defer such taxes to later years. See the example below.

Assumes gift of cash invested in publicly traded stocks, 5% growth and 2% dividend, 20% capital gain tax rate, 3.8% net investment income tax rate, 33% average tax rate for potential income tax savings, and the following design parameters:

1	2	3	4	5	6	7	8
\$10,000,000	\$10,000,000	0.6%	20 Years	\$58,756	\$9,999,000	\$1,000	\$3,333,000
FMV of Property Contributed	Cost Basis of Property Contributed	§ 7520 Rate at Inception	Lead Annuity Period	Initial Annuity Amount with 20% Annual Increase	Annuity PV Value & Potential Charitable Deduction	Taxable Gift (1 minus 6)	Potential Income Tax Savings (6 x 33%)

Year	CLAT Growth	CLAT Dividend Income	Charitable Annuity Payment (20% Annual Increase)	CLAT Remainder Value	Portion of Payment Made from Dividend Income	Portion of Payment Made from Deemed Sale of Property	Realized Capital Gain on Deemed Sale of Property	Grantor's Tax Due on CLAT Taxable Income
1	500,000	200,000	-58,756	10,641,244	-58,756	0	0	-47,600
5	638,160	255,264	-121,836	13,534,783	-121,836	0	0	-60,753
10	844,173	337,669	-303,168	17,762,131	-303,168	0	0	-80,365
15	1,057,392	422,957	-754,379	21,873,812	-422,957	-331,422	168,729	-140,822
20	1,168,016	467,206	-1,877,137	23,118,404	-467,206	-1,409,931	867,632	-317,691
Total	17,205,319	6,882,128	-10,969,043	23,118,404	-5,753,825	-5,215,218	2,978,900	-2,346,925

Click [here](#) to download the detailed analysis of the above values.

With the increasing annuity design vs. level annuity, the **remainder value is \$23.11MM vs. \$16.89MM**, total **charitable payments are \$10.97MM vs. \$10.64MM** and total **Grantor income taxes are \$2.34MM vs. \$1.67MM**. GRATs, as covered in Strategy 3, can similarly benefit from such increasing annuity design.⁴²

RETURN TO TOPICS

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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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