PLANNING IN A LOW INTEREST RATE ENVIRONMENT

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I. Introduction

A. Estate planning professionals for many years have taken advantage of the rules adopted by the IRS for valuing partial interests in property and for setting the interest rates used in this process. By administrative necessity, the IRS must have a set of rules and interest rates that apply uniformly to all taxpayers, with only limited exceptions, even though this may result in anomalies when the rules are applied to a particular taxpayer's situation.

B. There are a number of estate planning techniques that take advantage of the IRS's valuation rules, including charitable remainder and lead trusts, qualified personal residence trusts, grantor retained annuity trusts, and installment sales.

C. In many cases, a substantial part or all of the potential benefit in these techniques is the result of the difference between the investment return that the taxpayer actually can achieve and the assumed rate of return under the IRS valuation tables. This spread also can be advantageous in lending-based transactions. If the assets sold in an installment sale, or purchased with borrowed funds, can achieve an investment return above the minimum interest rate that the IRS requires to avoid imputed tax treatment, there is a tax-free shifting of value.

D. The current interest rate climate can provide a special opportunity for clients to take advantage of some of these estate planning techniques. This outline describes the IRS interest rates that are relevant to estate planning techniques, and discusses which techniques best take advantage of the low interest rates.

II. IRS Interest Rate Used For Valuation of Partial Interests in Property

A. The fair market value of a life estate, an income interest for a term of years, a noninsurance annuity interest, a remainder interest, or a reversionary interest is its present value as determined under tables published in the regulations.

B. In determining a present value, the tables incorporate certain mortality assumptions, and assume a fixed rate of return for assets. Since 1988, the assumed rate of return is adjusted monthly. It is commonly referred to as the "Section 7520 rate." The Section 7520 rate is 120 percent of the applicable federal mid-term rate in effect under Code Section 1274(d)(1) for the month, rounded to the nearest two-tenths of 1 percent.

C. As explained below, the applicable federal rate is determined by reference to yields of U.S. Treasury obligations, and is therefore tied to the financial markets. The Section 7520 rate has been as high as 11.6% in 1989, but for June 2020 the Section 7520 rate is .6%

III. IRS Interest Rate Used For Loans and Installment Sales

A. In lending transactions, the key rate for income and transfer tax purposes is the applicable federal rate ("AFR"). The AFR became relevant to estate planning transactions as a result of the enactment of Section 7872 in 1984. Before 1984, a popular way to shift value to a younger generation, or to move income-producing property to someone who was in a lower income tax bracket, was to make an interest-free or below-market interest loan. The loan was not treated as a gift and there generally were no adverse income tax consequences to the loan.

B. This treatment changed when the U.S. Supreme Court ruled in *Dickman v. Commissioner*, 104 S. Ct. 1086 (1984), that an interest-free loan constituted a gift of the right to use the funds interest-free.

C. Congress subsequently enacted Section 7872 to address both the gift tax and income tax consequences of interest-free or below-market loans. Under Section 7872, if a loan does not state adequate interest, interest will be imputed. In a gift situation, the lender will be treated as if he made a gift of the imputed interest to the borrower, who in turn is treated as if he paid the interest to the lender. A gift, and taxable income, result.

EXAMPLE: Lynn lends $500,000 to her son Biff with no interest. An adequate interest rate is 2%. In the first year of the loan, Lynn will be treated as making a $10,000 gift to Biff and Biff will be treated as paying $10,000 of taxable interest to Lynn.

D. Interest is adequate if the interest rate stated at least equals the AFR. The AFR is set monthly. There are actually three AFRs, depending on the term of the loan:

	Term	**January 2020 AFR (Annual)**	**June 2020 AFR (Annual)**
Short-Term AFR	Not over 3 years	1.60%	0.18%
Mid-Term AFR	Over 3 years to 9 years	1.69%	0.43%
Long-Term AFR	Over 9 years	2.07%	1.01%

In addition to publishing the monthly AFRs based on annual payments or compounding, the IRS publishes the rates based on semi-annual, quarterly, or monthly payments or compounding.

E. The AFR also is relevant in determining whether a promissory note issued in an installment sale bears sufficient interest to support the face value of the note. If the interest rate is insufficient, the face value of the note will be discounted in determining its value (as is true with any fixed-return obligation). For this purpose, the IRS has taken the position, which was accepted by the Tax Court, that a note must state interest at least equal to the relevant AFR to avoid being discounted. *See Frazee v. Commissioner*, 98 T.C. 554 (1992). Thus, in

installment sale transactions, estate planners look to the AFR as the floor on the interest rate that can be used.

EXAMPLE: John sells stock worth $1,000,000 in his business to an irrevocable grantor trust for the benefit of his children. The trust gives John a $1,000,000 20-year promissory note, with interest at 1.01%. At the time of the sale, the AFR is 1.01%, and the prime rate being charged by most banks is 4%. The interest rate on the note should be considered adequate to support a $1,000,000 face value, despite the fact that it is below the commonly available commercial borrowing rates.

IV. Impact of Interest Rates on Various Techniques

A. In general, a lower Section 7520 rate will impact the valuation of partial interests in property as follows:

1. A lower rate will decrease the value of income interests (because less income is assumed to be produced) and increase the value of remainder interests that follow income interests.

2. A lower rate will increase the value of annuity interests (because the fixed annuity amount is relatively more attractive as less income is produced) and will decrease the value of remainder interests that follow annuity interests.

3. The interest rate has no meaningful impact on the value of unitrust interests, since the amount paid varies with the annual value of the property.

B. In addition, a lower AFR or Section 7520 rate means that someone with a high return investment will benefit more from implementing a technique that takes advantage of the spread between the actual rate of return and the IRS-assumed rate of return.

C. Charitable Remainder Annuity Trust. A lower Section 7520 rate will increase the value of the annuity interest and reduce the value of the charitable remainder. Thus, a lower rate reduces the amount of the charitable gift of the remainder interest and the benefit of a CRAT.

Section 7520 Rate	Charitable Gift for $1,000,000 CRAT Paying 5% Annuity For Life of 60 Year Old with Annual Payments
.6%	$5,350
4%	$328,875
8%	$533,625

D. Charitable Lead Annuity Trust. A lower Section 7520 rate will increase the value of the charitable annuity and therefore be beneficial in a CLAT because it lowers the value of the gift of the remainder interest. The greater the yield of the assets that the grantor uses to fund the trust, the more that a lower Section 7520 will undervalue the remainder interest.

Section 7520 Rate	Charitable Gift for $1,000,000 CLAT Paying 5% Annuity For 20 Years
.6%	$939,680
4%	$679,515
8%	$490,905

E. Grantor Retained Annuity Trust. The goal in a GRAT is the same as the goal in a CLAT — increase the value of the annuity interest and to reduce the value of the gift of the remainder interest. Therefore, a lower Section 7520 rate is better.

Section 7520 Rate	Gift for $1,000,000 GRAT Paying 10% Annuity For 10 Years (Grantor is Age 60)
.6%	32,220
4%	$188,910
8%	$328,990

F. Qualified Personal Residence Trust. The right to occupy a residence for a term of years is the equivalent of an income interest. A lower Section 7520 rate reduces the value of an income interest and, therefore, increases the value of the gift of the remainder interest. Thus, a lower Section 7520 rate negatively impacts QPRTs.

Section 7520 Rate	Gift for $1,000,000 QPRT For 15 Years (Grantor is age 60)
.6%	$673,780
4%	$409,250
8%	$232,350

G. Installment Sale. The impact of a lower interest rate on an installment sale is self-evident. A lower rate means less will be paid back to the seller over the term of the note, leaving more property for the purchasing family members.

Long-Term AFR	**Total Note Payments** **Sale of $1,000,000 of stock for 10-Year Amortized Note With Interest at AFR**
1.01%	$1,051,770
4%	$1,214,940
78%	$1,455,930

V. Low-Interest or Interest-Free Loans

A. A simple way for a client to take advantage of the current low interest rate environment is to lend funds at the AFR to a child, grandchild or trust for the benefit of one or more descendants, to enable the recipient to take advantage of investment opportunities with a potential for high returns.

EXAMPLE: Clara creates an irrevocable grantor trust in January, 2020 for the benefit of her descendants. Clara makes a $1,000,000 taxable gift to the trust in June, 2020, which she splits with her spouse, and which uses a portion of their applicable exclusion amounts. They allocate GST exemption to completely exempt the trust. Thus, after the gift, they have a $1,000,000 trust that is completely exempt from gift, estate and GST taxes. In June 2020, Clara lends an additional $2,000,000 to the trust for a 10-year note bearing interest at 1.01% annually (the long-term AFR). The principal is due in a balloon payment at the end of the term.

B. Several benefits may result from this arrangement.

1. The trust has obtained $2,000,000 of investment capital at a rate significantly less than what is available commercially.

a. If the trust invests the $2,000,000 and earns a return of 10% annually over 10 years, it will have $5,187,485 at the end of 10 years. (This is in addition to the original $1,000,000 corpus received by gift and whatever investment return it has produced.)

b. The annual interest cost for the loan is $20,200 (1.01% of $2,000,000), or $202,000 in total over 10 years.

c. After the payment of principal, the trust will have $2,985,485 remaining ($5,187,485 less $2,000,000 less $202,000).

2. If the trust is structured as a grantor trust, the grantor will be responsible for all income taxes on income generated by the trust. In addition, the annual interest payments on the loan will not be taxable income to the grantor. In the foregoing example, the annual $20,200 of interest payments to Clara will not be taxable income to Clara.

3. There is no additional gift or generation-skipping transfer to the trust as a result of the loan. If the trust also earns 10% per year on the $1,000,000 corpus received from gifts, it will hold over $2,593,342 of assets after 10 years, all of which is exempt from gift, estate and GST taxes.

C. A client should not make a loan to a grantor trust that has no other assets. The same principles apply here as apply in the installment sale context. If the trust has no other assets, there is a risk that the IRS could treat the loan as not bona fide and recharacterize it.

1. In particular, the IRS could argue that the AFR does not constitute an adequate interest rate for a loan that has a substantial risk of default because of the lack of independent assets with which to repay it. This would enable the IRS to discount the value of the note and treat the loan as a part loan/part gift.

2. In the installment sale context, many tax professionals believe the trust should be separately funded with assets having a value at least equal to 10% of the note.

3. In addition to ensuring a trust is sufficiently capitalized to support a loan or sale transaction, it has also become more common that a personal guarantee is given to support a portion or all of the debt owed to the seller or lender. In some cases, where a client does not have sufficient available exclusion to fund a seed gift to support the transaction, practitioners argue guarantees can stand in the place of the seed gift. For example, a guarantor could guarantee 10-20% of the debt, replacing a seed gift of similar amount. The guarantee often comes from a beneficiary of the trust, but that beneficiary must have his or her own assets to support their ability to pay if such a guarantee was enforced If the debt is guaranteed by a third party, then that creates the question of whether a guarantee fee must be paid to avoid a deemed gift being made by the third party. The theory supporting guarantees is that in commercial transactions, lenders routinely require guarantees in addition to requiring certain levels of equity and the receipt of security.

D. In an installment sale to a grantor trust, the death of the grantor while the note is outstanding may require the grantor, his or her estate, or the trust to recognize part or all of the unrealized gain on the asset sold. *See* Treas. Reg. § 1.1001-2(c), Example 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985).

1. This is not an issue in a loan transaction. The grantor's death at most should cause currently unpaid interest and future interest payments to become taxable for income tax purposes, since now the loan is between a decedent's estate or living trust and an irrevocable trust.

2. Interest payments made in taxable years preceding the decedent's death should not become taxable at the decedent's death.

3. If the terms of the loan provide for deferral of payment of the interest until the end of the note term, then the death of the grantor could create a significant taxable event when the interest is paid. Under Section 7872, to avoid imputed interest and imputed gifts in a term loan, the stated interest must be at the AFR and the interest must be paid or compounded at regular intervals (for example, paid or compounded annually if the annual AFR is used). If the payment of interest is deferred until the end of the term, then to avoid a gift, the interest on a 10-year $2,000,000 note at 1.01% is not $202,000 (10 x $20,200); due to compounding, it must be $211,433.

E. In the proper circumstances, the client may want to consider an interest-free loan instead of a low-interest loan.

1. If the loan is made to a grantor trust, the grantor should not have to recognize imputed interest income, because the loan is not being made to a separate taxpayer.

2. There will be an imputed transfer that is treated as a gift. In a term loan that charges no interest, the amount of the gift will equal the difference between the amount lent and the present value of all principal payments due under the loan, discounted using the relevant AFR on the date of the loan. The gift is deemed to occur on the date of the loan.

EXAMPLE: Chris makes an interest-free loan of $2,000,000 to an irrevocable grantor trust that he previously created and funded with $3,000,000. The term of the loan is 10 years, with the principal due in a single balloon payment at the end of the term. If the AFR at the time of the loan is 1.01%, the present value of the loan is about $1,808,785, and Chris is treated as making a gift of $191,215 ($2,000,000 less $1,808,785).

3. An individual also could make an interest-free demand loan to a grantor trust. With a demand loan, the imputed interest each year is treated as a gift in that year.

EXAMPLE: On January 1, 2019 Chris makes a $1,000,000 interest-free demand loan to an irrevocable grantor trust. The Blended Annual Rate published by the IRS for 2019 is 2.42%. Chris is treated as making a gift of the imputed interest on the loan for the year, which is $24,200.

The danger with demand loans is that the lender cannot lock in an interest rate. If the AFR goes up, there will be more imputed interest and a larger gift.

F. Renegotiation of the Interest Rate on Existing Loans

1. During 2020, interest rates have fallen very fast and planners may want to consider renegotiating the terms of some older loans.

   <u>EXAMPLE</u> In June 2018, Father sells stock in a closely held business to a grantor trust for the benefit of has children. As part of the transaction, the trust signs a note with a 10-year term for $2,000,000 with interest paid annually at the long-term AFR, which was 3.05%. Just two years later in June 2020, the long-term AFR with annual payments is 1.01%. Reducing the interest rate on the note would save the trust $40,800 annually.

2. To simply have the parties restate the note at a lower interest rate runs the risk of Father making a gift to the trust of the interest being given up. The safest course for changing the terms of a promissory note is to provide consideration, including:

   a. Changing the terms of the loan, for example the length of the term of repayment of the loan,providing security for the loan (if not previously provided) or increasing the penalty rate of interest in the event of default; or,

   b. Making a significant principal prepayment.

VI. Grantor Retained Annuity Trust

A. A grantor retained annuity trust ("GRAT") is a trust to which the grantor contributes property and retains the right to receive a fixed dollar amount annually for a period of years. At the end of that period, any remaining property is typically distributed to members of the grantor's family or trusts for their benefit. Since the family does not receive any property until after the annuity term, the value of the gift is not the full value of the property transferred to the trust. Rather, it is the value of the property reduced by the value of the annuity interest the grantor retains. The value of the annuity interest, and thus the value of the gift, is calculated using the Section 7520 rate for the month the GRAT is created. As noted previously, the lower the interest rate that applies, the smaller the gift. Thus, as interest rates have fallen recently, the GRAT has become a more attractive technique.

   EXAMPLE. A 55-year old individual transfers an asset worth $1,000,000 in June, 2020, and retains the right to an annuity of 8% of the value of the assets ($80,000) per year for 12 years. The Section 7520 rate for the month is .6%. The valuation tables assume that the assets in the trust will earn only .6% per year, so the 8% annuity will require the use of trust corpus and use a large share of the corpus over the 12-year term. Under the IRS tables, the annuity has a value of $923,584. The gift, therefore, has a value of $76,416. If, in fact, the asset in the trust returns 8% or more per year, the trust still will hold at least $1,000,000 at the end of the 12 years.

B. A trust in which the grantor retains the right to an annuity payable from income and principal will be a grantor trust for income tax purposes. IRC § 677. Thus, during the annuity term, a GRAT is a grantor trust.

C. For a GRAT to be successful, the grantor must survive the term of the annuity payments. If the grantor dies during the annuity term, the trust property will be included in the grantor's estate.

D. Zero-Out GRATs

1. Section 2702 provides that an interest in a trust retained by the grantor will be valued at zero for purposes of determining the value of the gift to the trust, unless the retained interest is a qualified annuity interest, a qualified unitrust interest or a qualified remainder interest. The regulations under Section 2702 provide that the term of the annuity or unitrust interest "must be for the life of the term holder, for a specified term of years, or for the shorter (but not the longer) of those periods." Treas. Reg. § 25.2702-3(d)(3).

2. Despite the apparent statement in its own regulations granting three options for the term of a GRAT, the IRS took the position when issuing final regulations that an annuity payable for a term of years (with annuity payments continuing to the grantor's estate if he or she died during the term) always had to be valued as an annuity for a term of years or the prior death of the grantor. The position was not stated in the text of the final regulations; rather it was illustrated in one of the regulation's examples. *See* Treas. Reg. § 25.2702-3(e). Example 5. The requirement that one always must take into account the possibility of the grantor's death before the end of the term in valuing the annuity had the effect of reducing the value of the annuity, and increasing the value of the remainder interest and, therefore, the value of the gift for a transfer to a GRAT. Because of this and other requirements for valuing annuities, the IRS made it impossible to create an annuity in a GRAT with a value equal to the value of the property transferred (a "zero-out GRAT").

3. In *Walton v. Commissioner*, 115 T.C. 589 (2000), the taxpayer challenged the position in the IRS regulations. The Tax Court agreed that Example 5 in the regulations is inconsistent with the purposes of the statute and declared the Example invalid.

   a. The case involved Audrey Walton, the widow of Sam Walton. In 1993, she transferred 7 million shares of Wal-Mart stock to two GRATs in which she retained an annuity of 59.22% for two years. If she died during the term, the annuity payments would continue to her estate. The GRATs failed to produce the desired benefits. The price of Wal-Mart stock remained essentially flat for two

years, and all the stock was paid back to Mrs. Walton to satisfy the annuities.

b. Mrs. Walton brought the suit to avoid a large gift tax liability for the failed transfer. Her annuity interests valued for the full two-year term resulted in a gift to the GRATs of about $6,195. If her annuity interest was valued as a right to receive payments for two years or her prior death, as the IRS asserted, the gift would be $3,821,522.

c. The Tax Court first recognized that the IRS's regulations are entitled to considerable deference, but, as interpretative regulations, they still could be ruled invalid if they do not implement the congressional mandate in some reasonable manner. Based on the purpose of the statute and its legislative history, the court concluded that there was no rationale for requiring that the annuity be valued as a two-year or prior death annuity. In particular, the court noted that Congress referred to the charitable remainder trust rules as a basis for the Section 2702 provisions, and the regulations clearly allowed a two-year term to be valued without prior death contingencies in a charitable remainder annuity trust.

4. The ruling in *Walton* gives taxpayers the unique opportunity to implement a technique that has no tax cost if it fails. By structuring the GRAT so the value of the annuity equals the value of the property transferred, the taxpayer can avoid using applicable exclusion or paying gift tax. If the transferred assets increase significantly in value during the term of the GRAT, some of that appreciation is transferred out of the taxpayer's estate tax free.

5. A zero-out GRAT often works best when the annuity term is short (such as two years) and the GRAT is funded with one stock. A single stock that performs well during a two-year period easily can grow at an annual rate of 20% or more over that time frame.

EXAMPLE. In June 2020 when the Section 7520 rate is .6%, an individual creates a two-year GRAT and funds it with 40,000 shares of stock that has a current price of $25 per share ($1,000,000). He retains the right to receive an annuity of 50.452% each year for the two years. The value of the annuity is $1,000,000, and the gift when the individual creates the trust is zero. If the stock increases to $30 per share after one year, and $36 per share at the end of two years (a 20% increase each year), there will be $135,020 left in the GRAT at the end of the two years to pass to children tax-free:

Initial Value of Stock:	$1,000,000

End Year 1 Value	1,200,000
Annuity to Grantor:	(504,520)
Beginning Year 2 Value	$695,480
End Year 2 Value:	$834,576
Annuity to Grantor:	(504,520)
Property Remaining for Children:	$330,056

6. The property transferred to a two-year GRAT needs to sustain a high growth rate for only a short period of time for the GRAT to be successful. If the property does not appreciate as anticipated, it all is returned to the grantor in the annuity payments. The grantor then can create a new GRAT.

7. If a short term GRAT is used, it is better to isolate separate stocks in separate trusts so that the losers do not pull down the winners.

   EXAMPLE. In June 2020 when the Section 7520 rate is .6%, an individual creates a two-year GRAT and funds it with 40,000 shares of two stocks each of which has a current price of $25 per share ($1,000,000 per company for a total of $2,000,000). He retains the right to receive an annuity of 50.452% each year for the two years. The value of the annuity is $2,000,000, and the gift when the individual creates the trust is zero.

   Assume one stock increases from $25 to $30 per share after one year, and $36 per share at the end of two years and the other decreases in value over the same period from $25 to $20 and then to $12, there will be nothing left in the GRAT at the end of the two years to pass to children tax-free:

Initial Value of Stock:	$2,000,000
End Year 1 Value	2,000,000
Annuity to Grantor:	(1,009,040)
Beginning Year 2 Value	$990,960
End Year 2 Value:	$922,320
Annuity to Grantor:	(1,009,040)
Property Remaining for Children:	0

   The result of putting two stocks in one GRAT is that there is no benefit passing to the family. If, however, two separate GRATS were created, then one GRAT would have been successful and one would have failed.

8. One issue in a straight-term-of-years, or *Walton,* GRAT is how to minimize the estate tax consequences if the grantor dies during the annuity term.

a. In a GRAT with annuity payable for a term of years or the grantor's prior death, if the grantor is married, the trust simply can provide that all the trust property will pass to a marital trust for the surviving spouse, or will pour back into the grantor's estate plan and be allocated between the marital and nonmarital trusts.

b. If the grantor dies during the term of a term-of-years GRAT, the annuity payments do not stop at the grantor's death; they are paid to the grantor's estate (or revocable trust if so designated in the GRAT). It is not entirely clear whether the annuity payments and the GRAT corpus both can be given to the surviving spouse and merged back together to qualify all the property for the marital deduction.

9. Substitution of Assets with successful GRATs

a. Given the volatility in the equity markets, there can be significant short-term swings in values. Grantors of GRATs may want to capture one of the upswings before the market takes a down turn.

EXAMPLE On April 2, 2020, Father establishes a zero-out GRAT with 10,000 shares of Apple stock at a value of $242 per share. The Section 7520 rate in April 2020 was 1.2%. Under the terms of the GRAT, the trustee is obligated to pay Father an annuity of $1,221,840 on April 2, 2021 and $1,221,840 on April 2, 2022 (a total of $2,443,680). The assumptions underlying the IRS valuation tables is that the stock should increase in value to roughly $245 in one year and $248 in two years.

The value of the Apple stock moves to $349 per share on June 9 (roughly two months) and Father substitutes cash of $3,490,000 into the GRAT to preserve a benefit of $1,046,320 ($3,490,000 less $2,443,680). The cash is put in a savings account and will be used to pay the annuities on April 2, 2012 and April 2, 2022.

VII. Sale to "Defective" Grantor Trust

A. The sale of property to an irrevocable trust that is intentionally structured to be a grantor trust (often referred to as a "defective grantor trust" in the literature) is a variation on the commonly used installment sale. The taxpayer sells a high-growth asset for an installment note with interest set at the applicable federal rate (the "AFR"). If the asset grows in value at a rate above the interest rate on the note, the taxpayer's estate will be reduced.

B. The special twist when using a grantor trust as the purchaser in the sale is that the trust is not treated as a separate taxpayer for income tax purposes, so the sale does not cause the seller to realize or recognize capital gain. A regular installment sale reported under Code Section 453 permits the seller to recognize capital gain as

payments are received over the term of the installment note. When a grantor trust is used, even this deferred gain can be avoided entirely.

1. Because the trust is a grantor trust, interest paid on the installment note will not be taxable to the grantor. It is as if the grantor is paying interest to himself. Any income earned by the trust is taxed to the grantor by virtue of the trust's grantor trust status.

2. The trust can make payments on the note without concern about the tax consequences of the form of payment. For example, the trust can transfer appreciated assets to the grantor to make payments. This is not treated as a sale of the assets, as it would be if done by a third party purchaser.

C. There are two significant risks inherent in a sale to a grantor trust: (1) if the grantor dies while the note is outstanding, the IRS could treat the note as a retained interest in the trust, resulting in application of Section 2036 or 2702; and (2) if the grantor dies while the note is outstanding, the IRS could treat the conversion of the trust to a non-grantor trust as a taxable event for income tax purposes.

1. Retained Interest in Trust. In appropriate cases, the IRS could argue that the grantor's transfer of property to a trust in exchange for an interest-paying note is equivalent to a transfer with a retained interest. If the grantor then dies while the note is outstanding, Section 2036(a)(1) would apply.

a. The IRS is in the best position to make this argument when virtually all the trust income is being used to pay interest on the note. In that case, the grantor's note begins to look a lot like a retained income interest.

b. The position of IRS is further enhanced if the trust has little or no property other than the property acquired in the sale. This brings into play the comparable issues arising in classifying interests in a business as debt or equity. The debt/equity legal issue arises in cases in which the ratio of debt to equity is very high. For example, in a slightly different context, assume that parent funds a trust for her children with $100,000, and the trust forms a corporation to start a business. Parent then lends an additional $1,000,000 to the corporation to help finance the business activities. The IRS could argue that the parent's loan is really in part an equity investment because it is unreasonable to treat it as debt when the company is so heavily leveraged.

(i) In a similar fashion, the IRS could argue that an installment sale to a trust that has no other assets is not really a sale but

an additional contribution to the trust with a retained interest, analyzed under Sections 2036 and 2702.

(ii) Under Section 2702, the IRS could assert that the parent's retained interest must be valued under the qualified annuity interest rules, with the note payments representing the annuity. Normally, the interest rate on the note will be less than the rate necessary to cause the note payments to equal the face value of the note, calculated under Section 2702 (that is, less than 120% of AFR). The IRS then also could claim that the parent made a gift equal to the difference between the face value of the note and the Section 2702 value of the note payments.

(iii) Another avenue of attack is for the IRS to argue that the lack of equity support for the note means that its value should be discounted and the sale converted to a part sale/part gift.

EXAMPLE. Because the trust created by Client has little corpus other than the stock Client sells to the trust, the IRS concludes that the note is high risk and its value should be discounted from its $2,000,000 face value to $1,500,000. As a result, Client is treated as transferring $2,000,000 of stock to the trust in exchange for a $1,500,000 note, and is treated as making a $500,000 gift.

c. Many tax professionals believe the trust should be separately funded with assets having a value equal to at least 10% of the purchase price in the installment note, in order to minimize the possibility that the sale will be treated as not bona fide and recharacterized.

2. <u>Conversion of Trust to Non-grantor Trust at Grantor's Death</u>. Upon the grantor's death, the trust will lose its grantor trust status. If the note is still outstanding, the weight of authority is that the grantor's death should be treated for income tax purposes as a new exchange, in which the grantor transfers property to the trust equal in value to the amount of the note outstanding. In other words, an actual sale is deemed to occur simultaneously with the cessation of grantor trust status. *See* Treas. Reg. § 1.1001-2(c), Example 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222.

EXAMPLE. Client previously sold $1,900,000 of stock to a grantor trust for a 17-year installment note. The stock has a basis of $190,000. Client dies 10 years later, when the principal balance on the note is $1,000,000.

There are three theories as to the impact of the death of a grantor while a note for the sale of assets remains outstanding.

3. Recognition at Death. Under the first theory, the death causes the recognition of gain to the extent the note remains unpaid.

   EXAMPLE. Client previously sold $1,900,000 of stock to a grantor trust for a 17-year installment note. The stock has a basis of $190,000. Client dies 10 years later, when the principal balance on the note is $1,000,000.

   Under the recognition theory, Client is treated as having sold $1,000,000 of stock for a 7-year installment note (the remaining term on the original) note with a cost basis of $100,000. Client, and his successors-in-interest, have realized gain of $900,000 ($1,000,000 less $100,000 of basis) that is reportable under the installment rules.

   a. The sale probably would be treated as occurring immediately before the grantor's death rather than after his death. If the sale otherwise qualifies for installment treatment, the gain will not be recognized on the grantor's final income tax return. The gain would be income in respect of a decedent under Section 691 and would be reported by the grantor's estate or successor beneficiaries like any other installment receivable that is IRD.

   b. The trust may receive a basis step-up for that portion of the asset that is treated as sold at the grantor's death. In the foregoing example, the trust would end up with a basis in the stock of $1,090,000, consisting of $90,000 carryover basis (for the portion paid off during the grantor's life) and $1,000,000 acquisition basis for the portion of the stock treated as sold at the grantor's death.

4. Non-Recognition at Death. Under the second theory, some practitioners believe that the death of the grantor itself should never be a recognition event. The leading article that advances this argument is Blattmachr, Gans, and Jacobson, "*Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*", 97 J. Tax'n 149 (Sept. 2002) (hereafter "*Income Tax Effects of Termination*").

   a. The reasoning of the *Income Tax Effects of Termination* article is that death does not trigger a taxable event. The argument is based on the conclusion that Section 1001 does not apply at death because there is no amount realized on any transfer occurring as a result of death. For income tax purposes, one could equate the transfer from the grantor to the trust at death as equivalent to a bequest. Like a bequest, the decedent does not receive any consideration, so there can be no gain.

b. There are indications that the IRS agrees to at least some extent. Chief Counsel Advice 2009-23024 (Dec. 31, 2008), addressed a transaction when a nongrantor trust was converted to a grantor trust. The CCA reviews the authorities on termination of grantor trust status during life and then states: "We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner *which is generally not treated as an income tax event* [emphasis added]."

c. In its 2015-2016 Priority Guidance Plan, the Treasury identified a project to promulgate guidance on the basis of grantor trust assets at death under Section 1014. It was one of the few estate and trust related projects remaining on the 2017-2018 Priority Guidance Plan, issued October 20, 2017.

3. Partial Recognition. Under the third theory, the argument is made that there should be recognition of gain to the extent that liabilities exceed the basis of assets in the trust. This is based on the general principle that relief from liability is a taxable event. Assuming the deemed transfer is treated as taking place the moment before death, the grantor would recognize the gain on his her final income tax return. See Dunn and Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates*," 95 J. Tax'n 49 (2001).

D. The tax risks involved with a sale to a grantor trust should be avoidable if the note is fully paid during the grantor's life. An extremely long-term note or a note with a balloon principal payment is less likely to be paid in full while the grantor is alive. This of course means that the risk of confronting one of these tax issues is greater.

E. It also may be advisable to have a plan to pay off the installment note if the grantor's death appears imminent. For example, the grantor and the trust could take whatever preliminary steps are necessary to line up temporary financing from a bank or other commercial lender. If the grantor is near death, the trust could borrow from the bank and pay off the installment note. After the grantor's death, the grantor's estate could lend the money back to the trust in order to re-institute the private financing, and the trust would pay off the loan from the bank.

F. A major issue inherent in a sale to a grantor trust is how the trust will repay the note. Ideally, either the property already in the trust or the property sold to the trust should produce a cash flow in some manner in order to make payments on the note.

1. Interest should be paid annually on the note. The payment of interest is not necessary to avoid the income tax provisions in the imputed interest rules of Section 7872, since the interest is not being paid to a separate

taxpayer. The failure to provide for interest would discount the value of the note substantially, however.

2. If the asset sold is illiquid and not income producing, it is possible for the trust to make the installment payments, including the interest, by distributing assets in-kind to the grantor. Because the trust is a grantor trust, payment in-kind can be done without income tax consequences to either the trust or the grantor. However, if this is done on a consistent basis, it could increase the risk that the IRS would try to apply Section 2036 to the transaction, or otherwise try to collapse it. The IRS would argue that the grantor never really completely transferred ownership of the property if it was clear from the beginning that the trust would have to use the property itself to make interest payments.

3. Ultimately, the principal balance of the note also must be paid or discharged in some manner. This is often done by having the trust purchase an insurance policy on the grantor's life.

G. Grantor Trust Cross-Purchase Transactions.

1. This is a different twist on the sale to a grantor trust theme.

2. For clients that have pre-existing grantor trusts that may not be exempt from GST tax, the current low interest rates provide an opportunity to "freeze" the non-GST exempt assets and allow future appreciation to occur free of GST tax.

3. Here, client could create a new grantor trust, Trust B, and make a sufficient seed gift, and allocate her GST exemption to such transfer. Trust B could then purchase the assets of Trust A, a grantor trust set up by the same grantor. Trust A's value is frozen at the principal value of the promissory note plus the rate of applicable interest, and Trust B now has the highly appreciating property. Because Trust B used GST exempt assets to purchase Trust A's property, the Trust B principal and future appreciation will be exempt from GST tax.

VIII. Comparison of GRAT and Sale to Grantor Trust

A. Both the GRAT and the installment sale to a grantor trust are especially effective if the asset involved is stock in an S corporation or interests in another type of flow through entity, like a partnership or LLC.

1. The distributions that a flow-through entity typically makes to permit its owners (shareholders, partners or LLC members) to pay income taxes on entity income can be used to fund the annuity payments in a GRAT or the note payments in an installment sale.

2. Because the entity has flow-through tax treatment, and the GRAT or grantor trust also passes the tax through to the grantor, the grantor continues to report the taxable income from the property sold to the trust. The trust uses what amounts to pre-tax income to fund the annuity or note payments.

EXAMPLE. John owns 10% of an S Corporation. In recent years, the S corporation income allocable to his 10% share has been about $150,000 per year. The corporation has made cash distributions to him of about $75,000 per year, which is sufficient to pay John's tax liability attributable to the S corporation income.

John sells his stock in the corporation to a grantor trust in exchange for a note. John is still taxed on the $150,000 of S corporation income each year because the trust is a grantor trust. The trust, not John, is entitled to the S corporation distributions. The trust uses the distributions to make the note payments to John. John uses the payments on the note to pay his income taxes.

B. The following examples compare the GRAT with a sale to a grantor trust.

EXAMPLE. In June, 2020, when the Section 7520 rate is .6%, Client (age 55) transfers $2,000,000 of stock in his closely held company to a GRAT and retains an annuity of 8% ($160,000) per year for 12 years. The value of Client's retained annuity interest is $1,847,168, so Client makes a taxable gift of $152,832 when he creates the GRAT.

The company is an S corporation that distributes cash of about 11% per year, and the stock is also appreciating at about 5% per year. Thus, the GRAT will receive distributions of $220,000 per year, out of which it will pay the annuity.

At the end of 12 years, the stock, and the accumulated and reinvested S corporation distributions in excess of the annuity payments, will have an aggregate value of $4,311,700. If Client survives the 12-year term, this property will pass to his children without further transfer tax. However, if Client dies during the 12-year term, the GRAT property will be included in his estate.

EXAMPLE. Instead of using a GRAT, Client creates an irrevocable gift trust and funds it with a gift of $200,000 of stock in his closely held company. The trust is structured as a grantor trust. Client then sells $1,800,000 of the stock to the trust for a 12-year installment note, bearing an interest rate of 1.01% (the long-term applicable federal rate). The amortized payments to Client under the note are about $159,340 per year. At the end of 12 years, the stock, and the accumulated distributions in excess of the note payments, will have an aggregate value of $4,319,633.

In each of these examples, the trust beneficiaries will have a basis in the stock equal to the client's basis, adjusted under Section 1015(d) for any gift tax paid.

C. Advantages of an installment sale to a grantor trust.

1. An installment sale generally allows the client to use a lower discount rate. The interest rate required for the promissory note in an installment sale should be lower than the rate used for determining the value of an annuity interest in a GRAT. If the promissory note uses the applicable federal rate (AFR), the rate should be adequate to avoid gift tax consequences. In a GRAT, the value of the annuity is calculated pursuant to Section 7520 using 120% of the mid-term AFR. The lower rate for the promissory note often results in less property being paid back to the grantor. In the foregoing examples, the GRAT pays $160,000 per year to the grantor and the installment note pays only $159,340 per year. As a result, as the above examples indicate, the beneficiaries of the grantor trust will receive slightly more property than the ultimate beneficiaries of the GRAT.

2. An installment sale does not involve a direct mortality risk. If the client engages in an installment sale and dies before the end of the term of the promissory note, only the value of the unpaid balance of the note will be included in his estate. If he dies during the GRAT term, the entire value of the transferred property is included in his estate. However, as explained in the previous section, there are other possible tax consequences to dying during the term of an installment note.

    a. If the installment sale is not properly structured as an arm's length transaction, and the grantor dies while the note is outstanding, the IRS could treat the note as a retained interest in the trust, and include part or all of the trust in the grantor's estate under Section 2036.

    b. Upon the grantor's death, the trust will lose its grantor trust status. If the note is still outstanding, the grantor's death could be treated for income tax purposes as a new exchange, in which the grantor transfers property to the trust equal in value to the amount of the note outstanding. In other words, an actual sale is deemed to occur simultaneously with the cessation of grantor trust status.

3. An individual can engage in generation-skipping tax planning with a sale to a grantor trust by allocating GST exemption to the trust. In the above example, the individual would only need to allocate $200,000 of GST exemption to the trust, an amount sufficient to cover the initial gift. The GRAT is subject to the estate tax inclusion period (ETIP) rules. IRC § 2642(f). The grantor cannot allocate GST exemption to the GRAT until the end of the annuity term, at which time the then-current value of the trust is used for the allocation ($4,311,700).

4. There is more flexibility in structuring the payments to the grantor in an installment sale. For example, a balloon principal payment can be used,

the interest rate can be tied to the prime rate, or the term of the note and interest can be renegotiated after the sale is completed. A GRAT must pay the annuity every year and the annuity may change only as provided in the regulations. *See* Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

5. The installment sale can provide for prepayments of principal. That alternative is not available in a GRAT.

D. Advantages of a GRAT.

1. Because the GRAT is a statutorily sanctioned technique, there is more certainty about how it will be treated by the IRS. Assuming the value of the asset transferred to the GRAT is not questioned, the grantor knows how the transaction will be treated for transfer tax purposes. The determination of the values of the annuity interest and the gift are mechanical calculations using the IRS valuation tables.

   a. There are more uncertainties with an installment sale. As previously explained, if the grantor trust is not adequately funded or if the sale is not otherwise structured as an arm's length transaction, the IRS could challenge the substance of the transaction and treat it as something other than a sale.

   b. The one aspect of an installment sale that does not have to be strictly arm's length is the interest rate. As previously described, if the note bears interest at a rate equal at least to the AFR applicable for the term of the note, the interest should be adequate, even if the AFR is below the commercial interest rate for such a transaction. The IRS seems to have conceded that an interest rate at least equal to the AFR is sufficient. Treas. Reg. § 25.2512-8 states that, in determining whether a transfer is for insufficient consideration, if a buyer in a sale has issued a debt instrument as part of the consideration, then the debt instrument should be valued as provided in Treas. Reg. § 1.1012-2. Treas. Reg. § 1.1012-2(b)(1) states that the value of a debt instrument which has adequate stated interest (that is, interest at least at the AFR) is its face amount.

2. It often will be possible to have a smaller gift with a GRAT than with an installment sale transaction of comparable size. The conventional wisdom is that an installment sale transaction will run less of a risk of being challenged for lack of substance if the trust that is the purchaser has assets equal to at least 10% of assets being sold to it. If there is not a pre-existing grantor trust, this can mean that a considerable gift is necessary to fund the trust.

   a. For an installment sale, the gift is tied to the size of the transaction. For example, assume an individual wishes to sell $25 million of

stock to a grantor trust for a 20-year note. The individual would need to fund the trust with an initial gift of $2.5 million.

b. For a GRAT, the gift is tied to the size of the annuity and the length of the annuity term. Thus, if an individual wishes to transfer a significant asset that is expected to have a very high rate of appreciation, the gift may be more affordable if a GRAT is used. For example, assume the same individual transfers $27.5 million to a *Walton* GRAT paying $1,430,000 per year (5.2%) for a term of 20 years. If the Section 7520 rate is .6%, the gift upon creating the GRAT is $625,150.

3. The size of the gift also is relevant in considering the possibility that the asset transferred could drop in value, or grow only modestly. If this occurs, it is possible that all the assets in the GRAT or grantor trust will be paid back to the grantor to satisfy the annuity or note payments. If the grantor has made a larger taxable gift to fund the grantor trust in an installment sale, those assets all could end up back in his or her estate, with no restoration of unified credit used to make the initial gift, or no credit for any gift tax paid.

4. A GRAT may provide more protection if the IRS challenges the value of the asset being transferred.

a. In an installment sale, if the individual sells a $5,000,000 asset for a $5,000,000 note, and the value of the asset is increased on audit to $6,000,000, the individual would be treated as making a $1,000,000 gift.

b. In a GRAT, the annuity is usually expressed as a percentage of the initial fair market value of the assets contributed to the trust. If the IRS increases the value of the assets transferred to a GRAT on audit, the annuity also increases. The gift does not increase dollar-for-dollar with the increase in the value of the assets.

EXAMPLE. Jane, age 55, transfers a $5,000,000 asset to a GRAT and retains the right to receive a 14% annuity for 10 years or her prior death. Jane is treated as making a gift of $422,210. On audit, the IRS proposes to increase the value of the asset to $6,000,000. The annuity that the GRAT must pay each year would increase from $700,000 to $840,000. The gift would increase to only $506,652.

5. It may be possible, however, to avoid this drawback of an installment sale by including an adjustment clause in the installment sale documentation, so that the value of the note is adjusted if the value of the asset is increased on audit. The IRS traditionally has challenged this type of provision as a

savings clause that is against public policy. *See Commission v. Proctor*, 142 F. 2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944); Rev. Rul. 86-41, 1986-1 C.B. 300. In *Proctor* and Revenue Ruling 86-41, the taxpayer attempted to use an adjustment clause to change the amount of property transferred by gift or to require consideration to be paid for part of the transfer, if the value of the property transferred was adjusted as a later date. Neither situation involved a transaction structured from the beginning as a sale. In the sale context, an adjustment clause arguably should be upheld. *See King v. United States*, 545 F.2d 700 (10th Cir. 1976).

a. Wandry Defined Value Clause. A type of formula clause that has emerged won court approval in Wandry v. Comm'r, T.C. Memo 2012-88. The term "defined value clause" probably more accurately describes this type of clause because it defines the gift in terms of a defined dollar amount rather than a specific number of shares or units. Most people, however, refer to it now as a Wandry clause. The Service published a non-acquiescence to Wandry in I.R.B. 2012-46. Thus, it appears that the IRS is waiting for a more favorable opportunity to challenge the case.

b. In many situations, practitioners must use a Wandry defined value clause by necessity, because the value of the asset transferred could not be determined as of the date of the gift. A Wandry defined value clause also is used for gifts where the donor is having an appraisal prepared as of a certain date and needs to make the gift on that date.

   EXAMPLE: Alice owns a substantial interest in a family investment LLC. The LLC owns marketable securities and several parcels of commercial real estate. The family has an annual appraisal prepared as of December 31 of each year. It includes updated appraisals for the real estate and fixes valuation discounts for LP units. The appraisal report generally is issued two to three months after the end of year. On June 30, 2020, Alice gives $1,000,000 of LLC units to an irrevocable trust, with the value to be based on the appraisal report. When the appraisal report is issued, the LLC documents the actual number of LLC units transferred.

c. If a taxpayer uses a Wandry-type clause, the gift tax return should describe the gift as a dollar amount not a specific number of shares or units, or percentage interest. The taxpayer in Wandry did not do this, and this oversight gave the IRS its most powerful argument.

(i) In order to satisfy the adequate disclosure rules, it still probably is necessary to identify the number of shares or units that the taxpayer is claiming to have transferred.

(ii) This can be done by describing the gift first as a dollar amount but with an additional explanation: "The taxpayer transferred $2,500,000 of her interest in Dough Family Limited Partnership. Based on the appraisal by Honest Lee Valuation Group, the amount transferred equated to a 2.5% interest in the Partnership. However, the amount the taxpayer transferred is a fixed dollar amount of limited partner interest, and the percentage interest will be adjusted if there is a final determination for transfer tax purposes of a different value, so that the value of the interest transferred equals $2,500,000."

d. Be careful with the language of the defined value gift. See, Nelson v. Commissioner TC Memo 2020-81. In this case, the taxpayer transferred assets via gift and sale. The opinion turned on the language in the gift and sale documents, each of which said, "...assign...a limited partner interest having a fair market value of [$X] ...as determined by a qualified appraiser within [90/180] days of the effective date of this assignment." The court cited Petter and Wandry with approval, but noted in the case before it that "The clauses hang on the determination by an appraiser within a fixed period; value is not qualified further, for example, as that determined for Federal estate tax purposes." As a result the court refused to modify the percentages transferred in this case based on a revised value. Per the document the appraiser fixed the value of a partnership interest and the ensuing percentage interest transferred. The Nelson family was stuck with that determination.

e. There may be situations where it is not advisable to use a Wandry defined value clause.

(i) Many clients will make gifts well under the $11,580,000 (current) applicable exclusion amount. The unused exclusion amount provides some protection against audit (since the IRS receives no immediate return from challenging the value of the gift). And a Wandry provision may call unwanted attention to the return.

(ii) If the client is transferring an asset with extreme potential to increase in value, such as stock in a company that may be going public, it is worth considering whether it is better to accept a possible adjustment in value, and even pay gift

tax, rather than receive some of the asset back at a much higher value.