NAEPC Journal of Estate & Tax Planning

Click here to view Issue 32

Blanche Lark Christerson
Managing Director, Senior Wealth Strategist

Tax Topics

07/31/19

2019-07

Interest rates, GRATs, Sales and loans

Although interest rates have been moving up, they are now going down again, making certain planning techniques, such as Grantor Retained Annuity Trusts (GRATs) and Sales to "Defective" Grantor Trusts, especially attractive. These lower interest rates, coupled with the specter of possible restrictions on wealth planning depending on the outcome of the 2020 elections, suggest that now is a good time to revisit GRATs and Sales.

Here is how they work:

GRATs. The GRAT is a creature of statute and is nearly 30 years old. In this time, planners have mastered the technique, which allows donors to pass significant wealth to their heirs at little or no gift tax cost. The GRAT typically pays the grantor an annuity for two or three years, after which, whatever is left in the trust passes to the "remaindermen" (the next takers in line), who are usually the grantor's children.

GRATs are typically funded with property that is likely to appreciate significantly or is a "cash cow"; they are usually "zeroed out," so that the present value (or current worth) of the grantor's annuity interest equals virtually 100% of what the grantor put in the trust, thereby eliminating the gift to the remaindermen. If the grantor dies during the GRAT term, most (if not all) of the trust will be includible in the grantor's estate; yet if that happens, apart from the set-up costs, the grantor is basically where he would have been had he not created the GRAT.

> **Example.** Dad hopes to take his company public within the next year or so. The latest venture capital financing has valued the stock at about $10 per share. In August 2019, when the 7520 rate (see below) is 2.2%, Dad creates a three-year GRAT and funds it with 500,000 shares of stock worth $5 million; the trust uses stock to pay Dad an annual annuity of about $1.74 million (or about 34.8%). In Year 2, the stock is worth $15 per share; in Year 3, it is worth $20 per share. By the end of the GRAT, Dad has received over 377,000 shares, now worth over $7.5 million; the remaining

123,000 shares pass to his children, and are worth \$2.46 million…yet when Dad set up this GRAT, the gift to his children was just over \$1, and scarcely made a dent in Dad's current \$11.4 million gift tax exclusion.

Sale to a Defective Grantor Trust. Like the GRAT, the Sale is designed to pass potential appreciation gift-tax efficiently. Although not a creature of statute, the Sale is a well-regarded technique that allows donors to pass significant wealth to "dynasty" trusts that can benefit multiple generations. The donor/grantor creates (and funds) the trust and then later sells an asset to it, in exchange for a note that is usually interest-only (i.e., a balloon note). Because the grantor "owns" the trust for income tax purposes (i.e., it's a "defective" grantor trust), the grantor isn't taxable on the gain from selling the asset to the trust or on the trust's interest payments to him. If the grantor dies while the note is outstanding, the income tax consequences of the sale are uncertain (it's possible that gain might be recognized), although only the balance due on the note – and not the entire value of the trust – is includible in the grantor's estate.

Example. Mom wants to benefit children and grandchildren. She creates a trust for them and funds it with \$500,000 (a gift that uses up part of her \$11.4 million gift tax exclusion). Mom intends to take her company public within the next year or so. The latest venture capital financing has valued the stock at about \$10 per share. In August 2019, Mom sells 500,000 shares of the stock, worth \$5 million, to the trust in exchange for a promissory note that requires annual interest payments of 1.87%, the August 2019 annual mid-term applicable federal rate (see below), along with a balloon payment of principal in 9 years. Because this is a grantor trust, Mom is not taxable on the annual interest payments of \$93,500 she receives, nor does she recognize capital gain on the sale of the stock to the trust. In August 2028, the stock is now worth \$20 per share, and the trustee distributes 250,000 shares to Mom to satisfy the \$5 million note (Mom has also received a total of \$841,500 in interest payments that were paid from corporate distributions made to the trust). The trust still has 250,000 shares, worth \$5 million.

Comparing and contrasting. In the examples above, the GRAT returns more property to Dad than the Sale returns to Mom – yet the GRAT requires virtually no use of Dad's \$11.4 million gift tax exclusion, contrasted with the Sale's use of \$500,000 of Mom's \$11.4 million gift tax exclusion. Because of tax law rules, however, the GRAT is not designed to benefit multiple generations, whereas the Sale can; yet because the GRAT is set forth by statute, its mechanics are clear, whereas the Sale has some income tax uncertainty if the grantor dies before the note is paid off (see above). **These differences should not obscure some basic points, however:**

- Low interest rates enhance the gift-tax efficiency of GRATs and Sales.

- The current gift tax exclusion of \$11.4 million (\$22.8 million per married couple) is scheduled to revert to half those amounts in 2026, barring Congressional action.

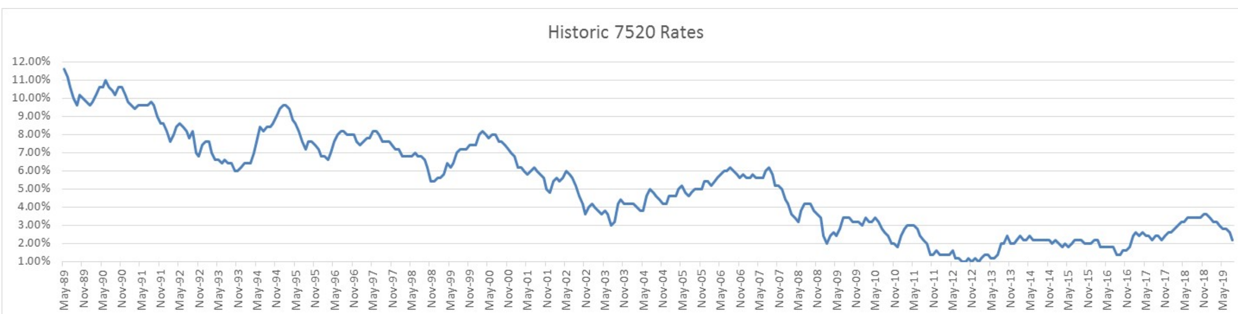
- Based on draft legislation from Sen. Bernie Sanders and comments from other Democratic candidates for president, a Democratic "trifecta" – as in Democratic control of the House, Senate and White House – after the 2020 elections (or those in 2022 or 2024), could lead to significant wealth planning changes, including limiting or eliminating the GRAT and Sale, reducing the gift tax exclusion to $1 million and the estate exclusion to $3.5 million, and steeply increasing gift and estate tax rates, which currently top out at 40%.

- Structures like the GRAT and Sale take time to implement: if, as suggested above, the political landscape changes, time may not be on the donor/grantor's side.

...and now about interest rates for tax mavens:

The **"7520 rate"** is named after the section of the tax law where it is found; it is viewed as a reasonable rate of return, and is used to determine the present value of various "interests," including annuities, income interests (whether they last for life or a term of years), "remainder" interests (what's left after the income interest ends) and "reversionary" interests (when the trust's creator gets the trust property back under certain conditions). The 7520 rate was first introduced in May of 1989, when it was 11.6%, its high-water mark; since then, rates have come down significantly, with the August 2019 7520 rate at 2.2%.

Here is a chart of historic 7520 rates through May of 2019:



source: author's compilation of rates

The **"applicable federal rates" (AFRs)** serve as a "safe harbor," and represent the minimum amount of interest that a lender must charge to avoid having a loan treated as "below market," and therefore subject to unintended gift or income tax consequences. (Below-market loans can crop up in many circumstances, including between family members, employers and employees, trusts and trust beneficiaries, partnerships and partners, etc.)

The AFRs have different compounding periods: annual, semiannual, quarterly and monthly, and are "short-term," "mid-term" and "long-term." Short-term means up to three years; mid-term means more than three years and up to nine years; and long-term means more than nine years (the 7520 rate is 120% of the applicable federal mid-term rate, rounded to the nearest 2/10 of 1% (0.20%, or 20 basis points)).

The AFRs reflect current economic conditions and are based on the corresponding average yields of various short-term, mid-term and long-term Treasury obligations. The IRS publishes the AFRs and 7520 rates monthly (each edition of *Tax Topics* typically lists the following month's 7520 rate and mid-term AFR – see below).

…circling back to the Sale and the GRAT. In the context of the Sale, the AFR is the interest rate used for the promissory note. As long as the note is for 9 years or less, the Sale's interest rate is *less* than the 7520 rate used in the GRAT computation, since the 7520 rate is *120%* of the applicable federal mid-term rate, rounded to the nearest 0.20% (20 basis points, or 2/10 of 1%). The Sale therefore typically has a lower "performance hurdle" than the GRAT. Yet regardless of which technique is used, the more the property in question outperforms the relevant interest rate, the more will be left for heirs; and the lower the interest rate, the better the potential results for the GRAT and Sale.

And what about intra-family loans? Yes, even parents (for example) must charge their children interest. And that's because of a 1984 Supreme Court case called *Dickman* (465 U.S. 330), which held that interest a lender could have charged on a loan (but didn't) was really a gift. Although the Court declined to say how to calculate that interest, Congress did. Thus, we have the rules dealing with "below-market loans" and the applicable federal rates discussed above – meaning that if lenders charge enough interest, they won't be treated as making a gift or having deemed interest income; if not, they will.

…which brings us to Mom and Son. Suppose that in August 2019, Mom loans Son money. How much interest she must charge depends on the loan's duration and the payment frequency. If Son's loan were for three years, with monthly interest payments, the minimum interest rate would be the monthly short-term AFR of 1.89%; if it were for five years, with quarterly payments, it would be the quarterly mid-term AFR of 1.86%; if it were for ten years, with semiannual payments, it would be the semiannual long-term AFR of 2.32%. And so forth.

While this seems straightforward enough, certain questions regularly come up in the family loan context, including the following:

What if the lender wants to charge higher interest? Suppose that Mom would like to receive more interest – how much can she charge?

- The AFRs set the *minimum* interest rate that can be charged without the loan being treated as "below market." Mom can charge more if she chooses, with the test, presumably, being "reasonableness," taking into account what a commercial lender might charge a similarly situated borrower. (An exceptionally high rate, for example, could be viewed as a gift from Son to Mom.)

Can payments be interest only? What if Son's payments only cover the interest and don't pay down any of the principal?

- A note can be structured as a "balloon" payment, whereby principal is due at the end of the note, and current payments only cover interest.

What is the minimum interest rate for demand loans? Suppose the loan isn't for a fixed number of years, but Mom can demand principal repayment at any time – how do the AFRs apply?

- If the principal amount remains outstanding for the entire year, that amount is multiplied by the "blended annual rate," which the IRS publishes in June of each year. (The blended annual rate is derived from the January and July short-term rates (compounded semiannually)). If some of the principal is paid off during the year, the interest presumably would be calculated on a pro-rated basis, using the January and July short-term rates (compounded semiannually). In effect, the interest rate on a demand note is adjusted every six months; as a practical matter, it would be simpler to lock in a low interest rate and make the loan a term note.

What about refinancing an existing loan? Suppose Mom's existing loan to Son carries a higher interest rate that she'd like to lower. If Son refinances, are there any gift tax implications, since Mom is giving up a higher return for a lower one?

- Although there does not appear to be any authority on the subject, prudence suggests that Mom alter one of the loan's terms to get something in return, such as, perhaps, a shorter payout or more frequent payments.

What about loan forgiveness? What if Mom gives Son a loan that carries sufficient interest, but Son's payments to Mom are spotty or non-existent? Can Mom forgive some of the debt using, say, her $15,000 annual exclusion ($30,000 if Dad agrees)?

- Yes, it is not uncommon for interest and principal to be forgiven annually until the note is gone, with the child never having paid anything. Yet if it appears that Mom is not serious about being repaid, the loan may be construed as a gift, notwithstanding Mom's loan documentation. (The issue might come up if Mom's estate is audited.) If Mom forgives the debt under her will, this becomes a taxable bequest; if she doesn't forgive the debt, her executor will be expected to enforce it.

Can the interest be accrued? Is it possible to simply accrue the interest and add it to the outstanding principal balance?

- While there appears to be nothing that precludes Mom from doing that, the question is how this might look to an auditor: did Mom genuinely intend to be repaid, or is the loan a disguised gift?

Other thoughts. Intra-family transactions always get close scrutiny from the IRS. Thus, for the loan to be respected and not treated as a tacit gift, the lender *and* the borrower both need to respect it. In other words, there should be a note that carries sufficient interest, payments should be made pursuant to the note's terms, and the lender should report those interest payments on her income tax return. Assuming the funds have been used to purchase, say, a principal residence, the borrower may be able to deduct the interest payments on his income tax return as long as the loan is secured by the residence. In short, the loan and its formalities need to be taken seriously – just like anything else in the planning arena.

August 7520 rate

The August 2019 7520 rate has dropped 0.40% (40 basis points) to 2.2%, from its July rate of 2.6%. The August mid-term applicable federal rates (AFRs) have also dropped, and are: 1.87% (annual), 1.86% (semi-annual and quarterly) and 1.85% (monthly). The July mid-term AFRs were: 2.08% (annual), 2.07% (semi-annual) and 2.06% (quarterly and monthly).

Blanche Lark Christerson is a managing director at Deutsche Bank Wealth Management in New York City, and can be reached at blanche.christerson@db.com.