



WRMarketplace

An AALU/GAMA Washington Report

The WRMarketplace is created exclusively for AALU/GAMA members by experts at Baker Hostetler LLP and the AALU/GAMA staff, led by **Jonathan M. Forster, Partner, Rebecca S. Manicone, Partner, and Carmela T. Montesano, Partner**. WR Marketplace #20-11 was written by **Michael P. Vito, Counsel and John F. DeStefano, Associate of Baker & Hostetler LLP**.

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TOPIC: Intergenerational Legacy Planning Opportunities in the Wake of the COVID-19 Crisis

MARKET TREND: Despite a notable rebound in some sectors of the market, economic uncertainty continues to push federal interest rates applicable to wealth transfer planning to historic lows, leaving a window of opportunity for clients to preserve wealth over multiple generations by utilizing their remaining generation-skipping transfer (“GST”) tax exemption and leveraging GST tax exempt assets without additional gifts.

SYNOPSIS: Statutory “hurdle rates” published by the IRS remain attractively low and, coupled with depressed asset values in many sectors, create opportunities for clients and their advisors to amplify the benefits of intergenerational legacy planning using loans between grantor trusts with different GST tax attributes, leveraged sales to grantor trusts that are exempt from the 40% GST tax (“GST exempt”), and late allocations of GST tax exemption to trusts that are not already exempt from GST tax (“non-exempt”) or have a mixed GST tax inclusion ratio.

TAKE AWAY: While statutory hurdle rates set new record lows and asset values remain off their previous highs, clients and their advisors may consider various wealth transfer planning approaches that magnify the benefits of GST tax exempt assets.

LEVERAGING GST TAX EXEMPTION

Applicable Federal Rates. Every month the IRS publishes the applicable federal rates (“AFRs”), which are the minimum interest rates that must be charged on a loan to avoid treatment as a “below-market loan” or a deemed gift, either of which could trigger gift tax.^[1] The June 2020 AFRs (for all compounding periods) are as follows:

Loan Term	Applicable Rate^[2]
Not over 3 years	0.18%
Over 3 years but not over 9 years	0.43%
Over 9 years	1.01%

In the context of wealth transfer planning approaches using loans, the AFR may be viewed as a “hurdle rate.” The first two examples in this report illustrate the potential effectiveness of two planning approaches related to amplifying the benefit of a client’s GST tax exemption using loans.

A Word on Loans. A loan is respected for legacy planning purposes only if it is a bona fide debt. Charging sufficient interest of at least the AFR is one of many factors courts consider when determining whether a bona fide debt exists. Other factors include whether (1) a written promissory note or other loan agreement exists, (2) there is fixed repayment schedule, (3) collateral or security is provided, (4) the borrower is solvent, and (5) loan repayments are timely made.^[3] This is not an exhaustive list of factors, and no single factor controls. Ultimately, the question is whether there is a genuine intention to create a debt with a reasonable expectation of repayment.^[4] Clients and advisors should consider these factors and other debtor-creditor formalities to ensure that loans used in legacy planning are respected as bona fide debt.

Loans Between Grantor Trusts with Different GST Tax Attributes. Often times, clients who engage in advanced legacy planning end up creating multiple irrevocable trusts, some of which may be GST exempt (such as an irrevocable life insurance trust (“ILIT”) holding a permanent life insurance policy to

which GST tax exemption was allocated) and others which may be non-exempt (such as trusts expected to be consumed during their children’s lives, or continuing trusts created from successful grantor retained annuity trusts (“GRATs”) to which GST tax exemption was not allocated).[5]

Example 1. Several years ago, Alvin created two trusts for the benefit of his descendants, one that is exempt from GST tax (“**Exempt Trust**”) and another which is not exempt from GST tax (“**Non-Exempt Trust**”). Both trusts are structured as “grantor trusts” for federal income tax purposes (meaning that all items of income, deduction, and credit are attributable to Alvin during his lifetime). Today, both trusts own marketable securities worth \$20 million.

Alvin is interested in planning opportunities that preserve wealth over multiple generations, but Alvin’s lifestyle needs are such that he does not wish to make any additional lifetime gifts. One solution may be for the Non-Exempt Trust to lend assets to the Exempt Trust. The loan may be structured as a balloon note, bearing interest at the relevant AFR. If the borrowed assets grow at a rate in excess of the AFR “hurdle rate” during the loan term, the net growth would accrue inside the Exempt Trust. This appreciation, when distributed to grandchildren or more remote descendants, would not be subject to the 40% GST tax. At the end of the term, the Exempt Trust would repay the loan to the Non-Exempt Trust.

Consider the growth that may accrue inside the Exempt Trust from a \$10 million loan from the Non-Exempt Trust over a term of three, nine, and fifteen years, with an assumed annual growth rate of 5% on the borrowed assets:

Additional growth accruing inside the Exempt Trust from a \$10 million loan over a three-year term, with annual interest payable at the June 2020 short-term AFR of 0.18%.

	Annual Growth	Interest Payment	Net Annual Growth
June 2021	\$ 500,000	\$ (18,000)	\$ 482,000
June 2022	\$ 524,100	\$ (18,000)	\$ 506,100
June 2023	\$ 549,405	\$ (18,000)	\$ 531,405
Total	\$1,573,505	\$ (54,000)	\$ 1,519,505

Additional growth accruing inside the Exempt Trust from a \$10 million loan over a nine-year term, with annual interest payable at the June 2020 mid-term AFR of 0.43%.

	Annual Growth	Interest Payment	Net Annual Growth
June 2021	\$ 500,000	\$ (43,000)	\$ 457,000
June 2022	\$ 522,850	\$ (43,000)	\$ 479,850
June 2023	\$ 546,843	\$ (43,000)	\$ 503,843
-Intervening Years Omitted-			
June 2027	\$ 655,424	\$ (43,000)	\$ 612,424
June 2028	\$ 686,045	\$ (43,000)	\$ 643,045
June 2029	\$ 718,197	\$ (43,000)	\$ 675,197
Total	\$5,426,140	\$ (387,000)	\$ 5,039,140

Additional growth accruing inside the Exempt Trust from a \$10 million loan over a fifteen-year term, with annual interest payable at the June 2020 long-term AFR of 1.01%.

	Annual Growth	Interest Payment	Net Annual Growth
June 2021	\$ 500,000	\$ (101,000)	\$ 399,000
June 2022	\$ 519,950	\$ (101,000)	\$ 418,950
June 2023	\$ 540,898	\$ (101,000)	\$ 439,898
-Intervening Years Omitted-			
June 2033	\$ 817,547	\$ (101,000)	\$ 716,547
June 2034	\$ 853,374	\$ (101,000)	\$ 752,374
June 2035	\$ 890,993	\$ (101,000)	\$ 789,993
Total	\$10,124,847	\$ (1,515,000)	\$ 8,609,847

The appreciation accruing inside the Exempt Trust is significant, even over a three-year term and assuming a reasonable 5% annual return. However, time is of the essence: if the AFR begins to increase, the results would not be as compelling. It is also possible that the approach could create the opposite effect if the borrowed assets decrease in value below the principal amount of the loan. This plan requires active monitoring and management. If the borrowed assets underperform expectations or economic forecasts turn negative, the trustees of the Exempt Trust may consider prepaying the loan and terminating the obligation.

Loans to GST Exempt Grantor Trusts. To leverage the impact of their GST tax exemptions, clients may also lend assets to new or existing GST exempt grantor trusts. This approach may be particularly

appealing to clients who would like to increase funding to trusts for their grandchildren, but who lack either sufficient GST tax exemption or available legacy capital to make large gifts.

Example 2. Brian is a successful business owner and has engaged in significant legacy planning, leaving him with \$1 million of remaining lifetime gift tax and GST tax exemption. Brian has 4 grandchildren and would like to create trusts for their benefit. After consulting with his advisors, Brian creates a new GST exempt trust for each grandchild and funds each trust with \$250,000. Brian structures the trusts as grantor trusts for federal income tax purposes.

To leverage the impact of his GST tax exemption, Brian lends \$1,000,000 to each grandchild's trust. The loans are structured as balloon notes with a 5-year term, bearing annual interest at the June mid-term AFR of 0.43%. Because the grandchildren are still young and have a long-term investment horizon, the trustees invest the loan proceeds in a diversified portfolio of large-cap growth stocks expected to return 7% per year over the next 5 years.

Over the term of the loans, the trustees of each trust pay \$4,300 per year to Brian in interest. Assuming the investment projections materialize, and the loans are repaid at the end of the fifth year, each grandchild's trust will have increased in value by (using rounded numbers) \$478,000 and have a total balance of \$728,000. On the other hand, if Brian had not issued the loans, each grandchild's trust would have increased by only \$100,000 and would have a balance of about \$350,000. By lending to the trusts, Brian is able to effectively double the impact of his remaining GST tax exemption.

To accomplish the same result without utilizing a loan approach (i.e., to transfer an additional \$378,000 to each grandchild outright, keeping in mind the assumption Brian has no remaining gift or GST tax exemption after the initial \$250,000 gifts), Brian would have to make an additional taxable gift of over \$1.88 million to each grandchild (\$1.88 million, reduced by 40% gift tax of \$752,000, further reduced by 40% GST tax of \$752,000 = \$376,000 net gift (rounded)).

Leveraged Sale to GST Tax Exempt Grantor Trusts. Often referred to as an "installment sale to a grantor trust," this legacy planning approach is better suited for a client who wishes to remove additional assets from his or her taxable estate.^[6] In short, a new or existing GST exempt grantor trust purchases assets from the grantor using a promissory note that bears interest at the appropriate AFR for the desired term. Many practitioners suggest that the trust's assets should total at least 10% of the balance of the note. For example:

Example 3. Carol would like take advantage of the temporarily increased gift and GST tax exemptions before the exemption amounts automatically decrease at the end of 2025.^[7] To do so, Carol creates a new grantor trust for the benefit of her descendants with a gift of \$5 million and allocates her remaining gift and GST tax exemption to the trust so that no gift tax is due and the trust is fully exempt from GST tax. (Carol could also have used a previously funded grantor trust if she preferred not to make an additional gift). Sometime later, Carol's advisors inform Carol that her financial position allows her to part with an additional \$15 million of assets without affecting her lifestyle needs.

Consequently, Carol decides to sell (and the trustees agree to purchase) \$15 million of marketable securities to the new grantor trust in exchange for a 9-year promissory note bearing interest at the June 2020 mid-term AFR of 0.43%. Annual interest payments on the note equal only \$64,500. All dividends

and capital appreciation realized on the purchased assets in excess of 0.43% will accrue inside the new grantor trust, exempt from any estate, gift, and GST tax.

Although such a purchase and sale with a grantor trust should not cause income tax consequences during the grantor's life, gain may be realized if the grantor dies prior to the note's full repayment. This risk can be addressed through life insurance owned by and payable to an ILIT to provide needed liquidity without increasing the client's taxable estate. Generally speaking, a sale to a grantor trust involves more risk than a straightforward loan and should be undertaken with due care and caution.

LATE ALLOCATIONS OF GST TAX EXEMPTION DURING MARKET DOWNTURNS

Though broader market indices have mostly rebounded since their dramatic declines earlier this year, the value of some asset classes and market sectors remains depressed. This may present an opportunity for clients who have non-exempt trusts or trusts with a mixed GST tax inclusion ratio (i.e., a trust that is only partially exempt from GST tax) to make a more efficient late allocation of GST tax exemption.

Timely allocations of GST tax exemption are made either on a timely filed gift tax return or via the "automatic allocation rules," and the amount of exemption allocated is based on the value of the assets as of the date of the transfer. On the other hand, late allocations of GST tax exemption are based on the value of the trust assets as of the date of the late allocation (or as of the first day of the month the late allocation is made).^[8] If time has passed since the initial transfer, the trust assets may have significantly increased in value, thus requiring a greater amount of GST tax exemption to convert non-exempt trust assets to GST exempt assets. When asset values decline, clients have an opportunity to more efficiently utilize their GST tax exemption with a late allocation. For example:

Example 4. Debbie is a retired executive of Big Hotel Group, Inc. ("BHG"). On January 15, 2016, Debbie funded a 2-year "zeroed-out" GRAT with \$3 million worth of BHG stock at a price of \$60 per share (50,000 shares). When the GRAT terminated, the stock had appreciated to \$140 per share, leaving a remainder (net of the GRAT annuity payments) of approximately \$2.875 million (20,500 shares) in a continuing trust for the benefit of Debbie's daughter and her descendants. As is fairly common, Debbie decided not to allocate GST tax exemption to the continuing trust upon the GRAT's termination.^[9] As of June 1, 2020, the price of BHG's stock closed at \$95 per share and the trust had a value of \$1.95 million (approximately).

Debbie would like to utilize her temporarily increased GST tax exemption without transferring any additional wealth. After consulting with her advisors, Debbie decided to make a late allocation of approximately \$1.95 million of her GST tax exemption to the non-exempt trust to convert its status to GST exempt. Debbie's advisors prepared and filed the gift tax return before June 30, 2020, electing to have the late allocation apply to the trust's value as of June 1, 2020.

Assuming the COVID-19 pandemic continues to fade and the price of BHG stock returns to a price of \$140 per share, all of the trust's appreciation will be exempt from GST tax. Had Debbie waited until the stock price fully recovered, she would have had to make a late allocation of nearly an additional million dollars of GST tax exemption to achieve the same result.

The results of a late allocation of GST tax exemption may be even more dramatic where a non-exempt trust owns an interest in an operating business that has yet to fully recover from the crisis.

TAKE AWAY

While statutory hurdle rates set new record lows and asset values remain off their previous highs, clients and their advisors may consider various wealth transfer planning approaches that magnify the benefits of GST tax exempt assets.

NOTES

[1] See Internal Revenue Code (“Code”) §§1274 and 7872. A below-market loan is any loan where the amount loaned exceeds the present value of all payments due under the loan.

[2] See Revenue Ruling 2020-12.

[3] See *Dickenson v. Commission*, T.C. Memo 2014-136.

[4] See *Lifton Bus. Sys., Inc. v. Commission*, 61 T.C. 367 (1973).

[5] GRATs are discussed in further detail in prior reports including *WRMarketplaces Nos. 20-06, 15-34, and 14-8*.

[6] The concept of an installment sale is discussed in greater detail in *WRMarketplace No. 20-06*.

[7] The Tax Cuts and Jobs Act of 2017 (“TCJA”) doubled the lifetime estate, gift, and GST tax exemption amounts from a baseline of \$5 million to \$10 million per individual. Adjusted for inflation, the 2020 estate, gift, GST tax exemption amounts are \$11.58 million. This provision of the TCJA automatically sunsets at the end of 2025, at which time the exemption amounts will revert to a baseline of \$5 million.

[8] As a matter of convenience, Treas. Reg. §26.2642-2(a)(2) allows a taxpayer to elect to value the property subject to the late allocation as of the first day of the month during which the allocation is made, instead of the default rule to value the property as of the date the late allocation is made.

[9] GST tax exemption cannot be allocated to a GRAT until after the GRAT term expires (i.e., until the close of the estate tax inclusion period (“ETIP”) under Code §2642(f)) at which time the trust assets have likely appreciated significantly. For that reason, GRATs are generally considered to be an inefficient GST planning vehicle and clients often opt not to allocate GST exemption when the ETIP period closes.