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Update on COVID-19 Pandemic Tax Relief and Planning Opportunities

The COVID-19 pandemic and accompanying economic downturn continues to create unprecedented challenges for individual and business taxpayers. Federal and state governments are contending with significant budget deficits but have successfully enacted several tax relief measures including increased flexibility, additional time to meet tax obligations, and relief from a number of compliance actions. Below are some highlights of recent developments in the U.S. tax arena in connection with the COVID-19 pandemic as well as several planning opportunities to consider with your Andersen advisor.

CARES Act: Technical Correction for Qualified Improvement Property Provides Retroactive Tax Relief

The CARES Act provides a long-awaited technical correction for qualified improvement property (QIP), enabling taxpayers to claim 100% bonus depreciation on eligible QIP. The amendments are retroactive to the effective date of the Tax Cuts and Jobs Act (TCJA) and are applicable to property placed in service on or after January 1, 2018. Taxpayers may either file an amended return for 2018 and 2019 taxable years or file a Form 3115, *Application for Change in Method of Accounting*, to reflect the cumulative amount of QIP depreciation (including bonus depreciation) to which the taxpayer is now entitled.

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NOL Carryback Opportunities for Corporations Under CARES Act

On March 27, 2020, President Trump signed into law the CARES Act, which modifies numerous provisions in Sec. 172 of the Internal Revenue Code related to net operating loss (NOL) deductions and NOL carrybacks. The TCJA previously limited the use of NOL carryforwards to 80% of taxable income (prior to any NOL deduction) and eliminated the carryback of NOLs that were permitted prior to 2018. The CARES Act temporarily relaxes the NOL restrictions enacted by the TCJA. As a result of the CARES Act changes, many taxpayers now have an opportunity to file refund claims or amended tax returns to carry back NOLs they have generated and receive cash refunds. In addition, the opportunity to forgo the carryback period is available but requires the taxpayer to file an irrevocable election waiving the carryback period.

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Tax and Valuation Considerations in Financial Restructuring and/or Bankruptcy

The COVID-19 pandemic represents an unprecedented event for businesses of all sizes across the country. Whether a business was forced to completely shut down or was permitted to continue operations at a drastically reduced rate, emerging from such a harmful economic environment may require a financial restructuring and/or bankruptcy. The article accessible through the link below discusses certain critical tax matters that may be important to enterprises as they evaluate a financial or bankruptcy restructuring.

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Enhanced Deduction for Charitable Contributions of Inventory: Is Your Company Taking Advantage of This Cash Tax Savings?

The CARES Act temporarily increased the deduction limitation for charitable contributions of food inventory for contributions made during calendar year 2020 to provide increased deduction opportunities for businesses that are increasing their charitable activity in response to COVID-19. A significant cash tax benefit may be derived from certain philanthropic donations of inventory to qualified charitable organizations. Section 170(e)(3) provides taxpayers with an enhanced deduction in excess of the tax basis in the inventory for donations of inventory meeting certain requirements. The enhanced deduction is limited to donations of food inventory for non-corporate taxpayers. C corporations are entitled to an enhanced deduction for qualifying charitable contribution of all types of inventory.

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COVID-19 Pandemic – Accounting Method Planning to Defer 2019 Income to 2020

Taxpayers should consider ways to increase cash flow in light of the challenging environment presented by the COVID-19 pandemic. One alternative is to decrease cash taxes paid through accounting method planning. Taxpayers should identify accounting method changes that can be filed for 2019 under the automatic procedure by filing Form 3115, *Application for Change in Accounting Method*. Any automatic Form 3115 must be filed by the time the 2019 tax return is due. A non-automatic change is available for 2020 and must be filed by the end of the tax year. The article accessible through the link below provides a discussion of some of the ways accounting methods can help to decrease 2019 cash taxes. Taxpayers with net operating losses (NOLs) in 2019 or 2020 should also consider accounting methods planning to maximize losses that will be carried back under the five-year NOL carryback provisions under the CARES Act.

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Transfer Pricing in the Time of COVID-19

The COVID-19 pandemic has resulted in an unprecedented decline in economic activity. Corporate taxpayers find themselves confronting what for many has become an existential threat to their businesses. As a result, they are prioritizing cash-flow needs, while balancing other priorities, including safeguarding of supply chains and maintaining continuity of service to preserve customer relationships. Depending on the taxpayer's unique facts and circumstances, transfer pricing (TP) may be an effective tax planning tool to reduce global taxes, increase cash flows and reduce overall global tax risk.

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U.S. Offers Tax Relief to Both Individuals and Businesses with Employees Stranded Due to the COVID-19 Pandemic

Treasury and IRS issued guidance providing tax relief to both individuals and businesses affected by travel disruptions arising from the COVID-19 pandemic. The guidance temporarily relaxes U.S. rules for determining tax residency to allow for the fact that individuals may have to remain in the U.S. or another country as a result of travel restrictions. The relief also extends to foreign businesses that would otherwise have no permanent establishment or taxable presence in the U.S., but have foreign workers temporarily present in the U.S. as a result of the COVID-19 pandemic.

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Maximizing Cash Savings by Pairing the R&D Payroll Tax Credit with COVID-19 Payroll Tax Relief

Qualified businesses that are eligible to claim the research and development (R&D) credit to offset an employer's FICA payroll taxes may be able to increase their cash benefit by combining the payroll tax credit with recent COVID-19 payroll tax relief incentives. Qualified taxpayers can claim both the R&D payroll tax credit and the credits available under the Families First Coronavirus Response Act (FFCRA) and the employee retention credit under the Coronavirus Aid, Relief, and Economic Security (CARES) Act. Unlike the R&D credit payroll offset, which carries forward to future quarters, the employee retention and FFCRA credits in excess of the employer's FICA contribution result in cash refunds to the employer.

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To Help Businesses Survive the COVID-19 Pandemic, States and Cities Are Offering New Incentives and Relief Programs

Several states and cities are offering loans, grants and other incentives to help businesses weather the harsh economic environment created by COVID-19. At the same time, states struggling to contain budget deficits, such as California, are moving to scale back an important business deduction and impose a limit on the amount of credits that may be claimed.

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Transfer Pricing Documentation Best Practices

Internal Revenue Service (IRS) recently released a series of questions and answers in response to a perceived decline in the quality of transfer pricing documentation. IRS emphasized that insufficient documentation will not help avoid a penalty adjustment. This reinforces prior IRS guidance requiring transfer pricing reports to meet certain minimum quality standards.

Fundamentally, a “good” transfer pricing report should collectively provide a clear and convincing narrative. The narrative must be unambiguous in terms of how value is generated based on operations performed, assets held, and risks borne of each entity. All sections of the report should explicitly support the narrative and each section of the report should build upon the previous.

Given this quality standard, what are some best practices taxpayers should follow?

1. The executive summary should provide a clear roadmap of the transaction(s) analyzed.

A report can have exceptional content but may not be effective if not presented in an organized, understandable and persuasive manner. The executive summary must be clear, concise and offer a roadmap for the transaction(s) covered in the report (including the benchmarking ranges and tested party results). Auditors find helpful any summary outlining the transactions, how the related parties are characterized, which transfer pricing methods are used, and the benchmark ranges.

2. The company overview should speak to the company’s value.

The company overview is the taxpayer’s first chance to tell its story. It should discuss which unique factors enable the company to succeed and the company’s management and strategic approach, including any major recent changes. Finally, it should set up the “functional analysis” and “contribution analysis” sections, by mentioning the company’s key value drivers.

3. The executive summary should provide a clear roadmap of the transaction(s) analyzed.

A successful industry analysis will tie the company’s strategy to the realities of the industry in which it operates. These realities include: barriers to entry, customer segments and value proposition(s), success factors, market conditions and seasonality/cyclical factors, and potential inherent risks that may impact strategy. It should not simply be a rehash of secondary/syndicated industry reports and should clearly note the impact on the intercompany transaction(s). Whether the company competes in a product market, service market or some other type of market, it’s important to identify which factors impact profits generally and what the competitors do to defend pricing structures and minimize margin erosion. For example, in the absence of a clarifying narrative, transfer pricing examiners will tend to attribute above-normal profits to IP, even if the profits are not necessarily driven by IP but rather by other operational activities (e.g., services).

4. A strong functional analysis will incorporate a value chain analysis and contribution analysis.

The purpose of a value chain analysis is to describe the nature and scope of functions performed by each of the relevant entities compared to the full scope of functions performed by the controlled group as a whole. An effective report will directly tie the functions of the relevant entities to the key value drivers – i.e., the overall thesis which the narrative seeks to explain – and make these points convincingly.

5. The functional analysis should always have a conclusion.

The functional analysis should provide a clear conclusion as to the functional characterization of each related party. Often, reports simply contain a listing of what each related party does without providing a conclusion. For example, in a captive service provider model, the conclusion should clearly identify which related party is the risk-bearing principal entrepreneur, which related party is the no/low-risk captive service provider, and <u>why</u> these characterizations apply.

6. Include a “contribution analysis.”

A contribution analysis quantifies the relative contributions of a company’s key non-routine value drivers. By including a contribution analysis, a report provides a direct connection between the functions of the related parties and the share of group income/loss that each entity is entitled to receive. In other words, whereas a functional analysis explains who does what, a contribution analysis explains the value of who does what.

7. Explain any adjustments to comparable data.

In order to make benchmarking data more comparable to the tested party, transfer pricing regulations require adjustments be made in order to produce a more reliable result. When such adjustments are made, it should be clear why they are necessary and how they are computed.

8. Selection of method should link to the specific intercompany transactions and company facts.

The selection of transfer pricing method should tie directly to the specific facts where feasible. For example, rejecting the Comparable Uncontrolled Price (CUP) method because CUPs do not exist is often not a sufficient argument. Instead, describing why comparable transactions do not exist by noting the uniqueness of the transactions or challenges within the specific industry provides a more robust argument.

9. A high quality transfer pricing documentation is audit ready.

A high quality transfer pricing report should anticipate a tax auditor's questions and preemptively answer them. For example, whether there is any intellectual property and who owns it should be extremely clear so as to leave no room for counter arguments. If a report is vague or does not address the issue head on, it will likely raise more questions during an audit. A "good" report is unambiguous.

10. Transparency and consistency are key to support a taxpayer's position year after year.

A fundamental purpose of a transfer pricing report is to provide transparency. In addition, an effective report provides not just transparency but consistency as well. Or, in cases where there is a change from past treatment, an effective report explains the reasons that triggered the change. Above all, it's important for all claims to be fact-based in order to dispel any future claims of arbitrariness.

11. Ease of use.

An effective report is one that is clear and easy to understand. A high quality report will tell the taxpayer's unique story in a clear, unambiguous, and convincing manner. It should also be written to be as effective as possible in defending against a future audit. Following IRS best practices will ensure these objectives are met and provide the expected return on a taxpayer's investment in the documentation.

The Takeaway

It is important for taxpayers to follow best practices to ensure high quality transfer pricing documentation. A high quality report that tells the taxpayer's unique story in a clear, unambiguous, and convincing manner will be much more effective in defending against a future audit. Following the aforementioned best practices will ensure these objectives are met and provide the taxpayer the expected return on a taxpayer's investment in the documentation.

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Tax Consequence of a Foreign Partner Selling an Interest in a U.S. Partnership

Foreign partners invested in certain U.S. partnerships should be aware that a disposition of their interest could trigger U.S. tax.

Background

Prior to the Tax Cuts and Jobs Act (TCJA), U.S. Revenue Ruling 91-32 governed the U.S. income tax treatment when a foreign partner (i.e., nonresident alien individual or foreign corporation) transferred (sold/exchanged/disposed of) their interest in a partnership doing business in the U.S. The ruling treated the gain or loss of a partner's sale of interests as U.S. effectively connected (EC) gain/loss and thus, subject to U.S. taxation to the extent of the partner's interest in the underlying U.S.-based partnership assets. However, in *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3

(2017) (*Grecian Magnesite*), the Tax Court held that the foreign partner (in this case a corporation) was only liable to U.S. income tax on the portion of the gain that was attributable to U.S. real property interests.

In response to the decision in this case, Congress enacted Sec. 864(c)(8) as part of the TCJA. This provision treats the foreign partner's gain or loss from the transfer of an interest as EC gain/loss to the extent that such gain or loss does not exceed the portion of the foreign partner's share of gain or loss that would have been EC if the partnership sold all of its assets at FMV on the date of sale. This is distinct to other capital gains for non-U.S. persons which are generally not subject to tax except for investment in real estate.

Determination of Gain/Loss Under Section 864(c)(8)

To determine the amount of gain/loss now subject to U.S income tax on a foreign partner's sale of an interest in a U.S. partnership, the following steps apply:

1. Determine the foreign partner's outside gain/loss on the sale.

2. Determine the foreign partner's EC gains/losses in a deemed sale. This is calculated in sub-steps (a) through (c) below:

    a. Determine the partnership's deemed sale gains or losses, which are the amounts that the partnership would recognize upon the sale of all of the partnership's assets for fair market value on the date of sale.

    b. Determine the amount of the partnership's deemed sale gains or losses that would be treated as EC gains/losses. These are gains/losses attributable to a U.S. permanent establishment (i.e., an office or a fixed place of business in the U.S.) maintained by the partnership, with two exceptions provided in proposed regulations. Proposed regulations provide that gains or losses are not treated as effectively connected gains/losses if (1) no income or gain previously produced by the asset was taxable as effectively connected with the conduct of a trade or business within the U.S. by the partnership during the 10-year period ending on the date of the transfer, and (2) the asset was not used, or held for use, in the conduct of a trade or business within the U.S. by the partnership during the 10-year period ending on the date of transfer.

    c. Determine the foreign partner's distributive share of EC gains/losses in the partnership's deemed sale of each asset. A foreign partner's distributive share of deemed sale EC gain or loss generally is equal to the amount of such gain or loss that would be allocated to the partner under the partnership agreement.

3. Determine the foreign partner's ultimate gain/loss which will be subject to U.S. tax.

The ultimate gain or loss is equal to the **lesser** of the outside gain/loss (calculated in step 1) or the foreign partner's EC gain/loss in a deemed sale (calculated in step 2).

U.S. Tax Treaties

Generally, U.S. tax treaties provide that gains or losses from the sale of property attributed to a permanent establishment in the U.S. can be subject to U.S. tax. A partnership's permanent establishment is attributed to all partners. Thus, U.S. tax treaties generally do not provide relief for Sec. 864(c)(8). The one exception is for certain ships and aircraft. Many U.S. tax treaties exempt gains from the sale of ships and aircraft used in international traffic from U.S. tax, even if the gains or losses are attributable to a U.S. permanent establishment. The specifics of each treaty should be reviewed in detail to see if they offer any relief.

Anti-Stuffing Rule

An anti-stuffing rule is included in the proposed regulations to prevent inappropriate reductions in amounts treated as EC subject to tax under Sec. 864(c)(8). The provisions require that a transfer of property be disregarded for the purposes of calculating the EC gain/loss if the principal purpose of the transfer is to reduce the amount of gain treated as EC gain or increasing the amount of loss treated as EC loss.

Withholding Tax Guidance

Section 1446(f) states that purchasers of a foreign partner's U.S. partnership interest after December 31, 2017 are required to withhold 10% of the amount realized. The purchaser must report and pay the withholding tax within 20 days of the transfer and separately provide the partnership with the withholding certificate within 10 days of the transfer. An exception is provided under Notice 2018-29 if there is no gain recognized or if the EC gain is less than 25% of the overall gain. There is still much uncertainty over how these withholding rules will apply and further guidance is anticipated.

The Takeaway

The U.S. withholding, reporting and tax rules with regards to any transactions undertaken by foreign persons are complicated, and the sale of a partnership interest is no exception, especially after the landmark decision in *Grecian Magnesite* and the following changes made in the TCJA. Any partnership with foreign partners or any foreign partner should carefully review the rules with their tax advisor before undertaking any transaction and be fully aware of any gain which could be subject to U.S. tax. Even if a sale is not currently anticipated, now would be a good time to understand the basis of the partner's share in the partnership and its underlying assets and ensure this is closely tracked going forward.

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Valuations Play a Critical Role in Distressed Time

Due to the pandemic, businesses of all sizes nationwide have been forced to cease operations after being deemed nonessential. Many of the enterprises that have been permitted to remain open have experienced increased costs and drastic reductions in revenue. Meanwhile, usual overhead costs such as rent, payroll, debt service, and utilities continue to accumulate. As a result, many business and real estate asset values have become materially depressed. Valuations can play a critical role in decision-making for companies and individuals in financial distress or bankruptcy and obtaining a well-supported appraisal may even allow companies and individuals to take advantage of valuable tax opportunities during this time.

Tax Opportunities in the Current Environment

For companies and individuals looking to increase cash flow during this time, reduced business and property values may present certain opportunities for tax savings related to cancellation of debt and property tax/disaster relief.

Cancellation of Debt (COD) Income

If a company's debt is forgiven or discharged for less than the full amount owed, the difference between the settlement amount and the amount owed becomes taxable income unless an exception applies, such as if a corporation is insolvent or in a Chapter 11 bankruptcy.

Insolvency is a term for when an organization can no longer meet its financial obligations to its lenders as debts become due. To determine if a company is solvent, three tests are applied. All three of these tests – the balance sheet, the cash flow, and the adequate capital test – must be passed for a company to be considered solvent and therefore meet this exception to COD income.

- The first test is the balance sheet test. This test determines whether the company's asset value exceed its liabilities. The company's balance sheet is just the starting point for this test since the entries on the balance sheet do not necessarily reflect fair market value. A valuation expert can assist with determining the fair market value of the company's assets and liabilities. The fair market value is generally defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Since fair market value can be determined in various ways, an expert's advice and experience as to the most appropriate methodology in making this determination can be critical in meeting this test.

- The second test is the cash flow test. The purpose of this test is to assess whether the company incurred debts that are beyond its ability to pay as they mature. This test involves an analysis of projections of future financial performance.

- The third test is the adequate capital test. This test is meant to determine whether a company has adequate capital resources with which to continue operations by meeting operating expenses, recurring debt obligations, necessary capital expenditures, etc.

Federal and State Property Tax and Disaster Relief Opportunities

Given the current environment, property owners should consider whether they can take advantage of temporary or permanent reductions in property value to reduce property tax liabilities. Property owners should review local laws to determine whether their jurisdiction provides disaster relief or other procedures to reduce assessed values. There may also be opportunities for disaster loss relief for federal income tax purposes.

Appraising real property in the current environment can be challenging. Appraisers generally consider three approaches to value: income, market, and cost. Very few sales transactions involving asset classes such as office buildings, retail properties, and apartment buildings have closed since mid-March 2020. As a result, the valuation expert must rely primarily on the income approach. In doing so, significant judgement is required in determining appropriate cash flow projections and discount rates. Appraisers must be able to document and support their conclusions to withstand scrutiny from tax authorities.

Valuation in Bankruptcy

Finally, if a company does make the decision to file for bankruptcy, valuation will guide stakeholders throughout the stages of the bankruptcy process. This process includes consideration in critical areas such as adequate protection, plan confirmation, insolvency analysis, and ultimately fresh-start accounting.

Adequate protection refers to the protection offered to creditors of a failing business to ensure payment to these creditors using business assets essentially as collateral. Often, a qualified valuation expert must be engaged to determine the current value of the collateral securing a creditor's lien. Valuation is critical as it is used to determine the amount of the lien that is secured.

Additionally, for a company to emerge from Chapter 11 bankruptcy, a plan of reorganization, including the reorganization value, must be submitted to the court and approved. The value of the company must be determined as part of the plan and the value is used in determining what each stakeholder will ultimately receive upon exit from bankruptcy.

Finally, the company emerging from bankruptcy needs to allocate its total reorganization value to the various tangible and intangible assets. This is known as fresh-start accounting. Fresh-start accounting rules are set forth by Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 852, *Reorganizations*. The company is also required to follow guidance from FASB ASC Topic 805, *Business Combinations*, and perform a purchase price allocation of the business, including identifying intangible assets such as tradenames, technology, customer contracts, and goodwill. It is critical that the valuation professional understand the accounting rules and have expertise related to the valuation of businesses, including tangible and intangible assets, and the application of concepts such as economic obsolescence which are common in bankruptcy.

The Takeaway

Valuations play a critical role in times of financial distress and guide important decision-making related to businesses and assets. With few market indications available to substantiate values, it is more important than ever to seek assistance from an appraiser who can thoroughly analyze and support your value determination.

Planning Ideas in a Low Interest Rate Environment

Current interest rates are at historic lows, providing families unprecedented planning opportunities. Using debt to finance wealth transfers can be very effective and efficient, particularly for individuals who have used their lifetime gift exemption. If these transactions are executed properly, asset appreciation can be transferred to the next generation with little to no gift tax implications. This article will look at just some of these interest-rate driven transactions.

Intrafamily Loans

Intrafamily loans are the simplest form of planning in a low interest rate environment. An individual makes a cash loan to the person they wish to benefit with an interest rate based on the applicable federal rate (AFR), set monthly by the government. As of August 2020, the annual AFRs are as follows:

	Short-Term	**Mid-Term**	**Long-Term**
Loan-Term	1-3 years	3-9 years	Longer than 9 years
Annual AFR	0.17%	0.41%	1.12%

These low interest rates provide the transferee the ability to invest the funds with a low cost of capital. If the assets purchased appreciate in excess of the interest rate, the difference between the return and the interest will accrue to the borrower without any gift tax. Given these low rates, it takes little investment performance to exceed this hurdle.

To avoid being reclassified as a gift by IRS, loans must be properly documented, with all parties following the form of that documentation. It is important to note IRS often does scrutinize intra-family transactions more so than the same transaction between unrelated parties. The following steps should be followed to ensure the transfers are treated as a loan:

1. Ensure the borrower can repay before making the loan;
2. Document the loan with a promissory note;
3. Charge annual interest (or some other periodic interest);
4. Collateralize the loan;
5. The loan should have a fixed maturity date or be stated as a “demand” loan;
6. After the term of the loan, a demand for repayment must be made and, assuming the borrower is still solvent, actual payment is made;
7. Record keeping by both the transferor and transferee reflect the transaction as a loan; and
8. Ensure reporting for federal income tax purposes is consistent with a loan.

Generally, intra-family loans are structured to be interest only with a balloon payment when the loan matures. Such loans can also be refinanced providing flexibility between the transferor and transferee. The new terms of the loan must be negotiated and agreed to by both parties. In addition, part or all of these loans can also be forgiven as gifts. Provided taxpayers treat them as unrelated transactions and mind the income tax implications, intra-family loans can be a simple yet highly effective way to move wealth downstream.

Grantor Retained Annuity Trust (GRAT)

A GRAT is a transaction where the grantor contributes assets with appreciation potential to a trust in exchange for an annuity stream over a typically short fixed term (e.g., two years). Once the GRAT terminates, the remaining assets are distributed to the beneficiaries of the trust. Because the annuity payments are generally calculated such that their present value is equal to 100% of the asset(s) contributed value and therefore the remainder value is essentially zero at the time of the transfer, a GRAT provides the grantor the ability to transfer asset appreciation with little to no gift tax impact. Because there is no gift tax impact, enormous amounts of wealth can be transferred to a GRAT and there is no limit as to how many GRATs a taxpayer can establish.

The GRAT annuity payment is determined by the term of the trust and Sec. 7520 rate, which as of August 2020 is 0.4%. In order to be effective, the assets contributed to the GRAT need to appreciate at a rate in excess of that Sec. 7520 “hurdle” rate. With this low rate there is a tremendous opportunity to pass the appreciation of high-growth assets to beneficiaries gift-tax free. In additional, because GRATs are “grantor trusts” for income tax purposes, the grantor rather than the trust is responsible for paying the tax on income generated in the trust, thereby providing another “indirect” gift benefit.

There are however some downsides to GRATs. If the grantor dies during the GRAT term, generally all the assets will be included in the gross estate. However, since little to no gift-tax exemption was used in transferring the assets, the grantor is no worse off than if no planning has been done. Additionally, if the assets inside the GRAT underperform against the Sec. 7520 interest rate, the assets are returned to the grantor via the annuity payments and again, the grantor is no worse off. Also, due to IRS rules GRATs are generally not effective in multi-generational planning that would require the use of generation-skipping transfer (GST) tax exemption. Despite these considerations, in this low interest rate environment a GRAT can be an ideal tool to transfer significant wealth to the next generation with very little risk.

Installment Sale to Intentionally Defective Grantor Trust

Installment sales to intentionally defective grantor trusts (IDGT) are similar in concept to GRATs in that they are designed to move asset appreciation out of a taxpayer’s estate. In this transaction, a grantor “sells” an asset(s) to a trust in exchange for a promissory note. Like the intra-family loan above, the interest on the note is determined by the above-mentioned AFRs. To the extent that the asset appreciation exceeds that interest rate, that value inures to the trust tax-free and the note freezes the value in the grantor’s estate. The trust is considered “defective” because although transfers to it are complete for gift and estate purposes, for income tax purposes it is a grantor trust and not considered a separate entity from the grantor. Therefore, like the GRAT, the grantor will continue to pay the income tax on any income generated inside the trust. In addition, because the trust is considered grantor for income tax purposes, neither the sale to the trust nor the interest payments have any income tax ramifications.

While installment sales are similar in concept to GRATs, they are more complex transactions with additional considerations. First, the trust should be properly capitalized. This capitalization is necessary to protect against IRS disregarding or reclassifying the debt instrument by arguing the loan is not commercially reasonable because the borrower does not have any net equity. Therefore, unlike a GRAT, this transaction does require an upfront gift, unless there is an already funded trust. Although there are no set rules, many practitioners follow a guideline that the seed gift be at least 10% of the value of the property to be sold to the trust. Also, the promissory note should be executed following the same guidelines as mentioned above and bear the appropriate interest rate based on the term of the note. The installment sale is however superior to the GRAT in that there is no mortality risk so that the transaction can still be successful even if the grantor dies during the note term (only the note would be included in the estate). In addition, GST exemption can be allocated to the trust in this transaction, making it highly effective for multi-generational planning.

The Takeaway

Despite today’s many challenges, the current interest rate environment provides significant planning opportunities using the above, and other rate driven transactions. These interest rates along with still somewhat depressed asset values make this the right time to revisit family gift and estate plans and maximize wealth transfers to future generations.