trustate

Installment Sales to Irrevocable IDGTs

Monday, May 19, 2025
1:00 PM to 2:00 PM ET
(60 minutes)

Alan Gassman, JD, LL.M. (Taxation), AEP® (Distinguished)
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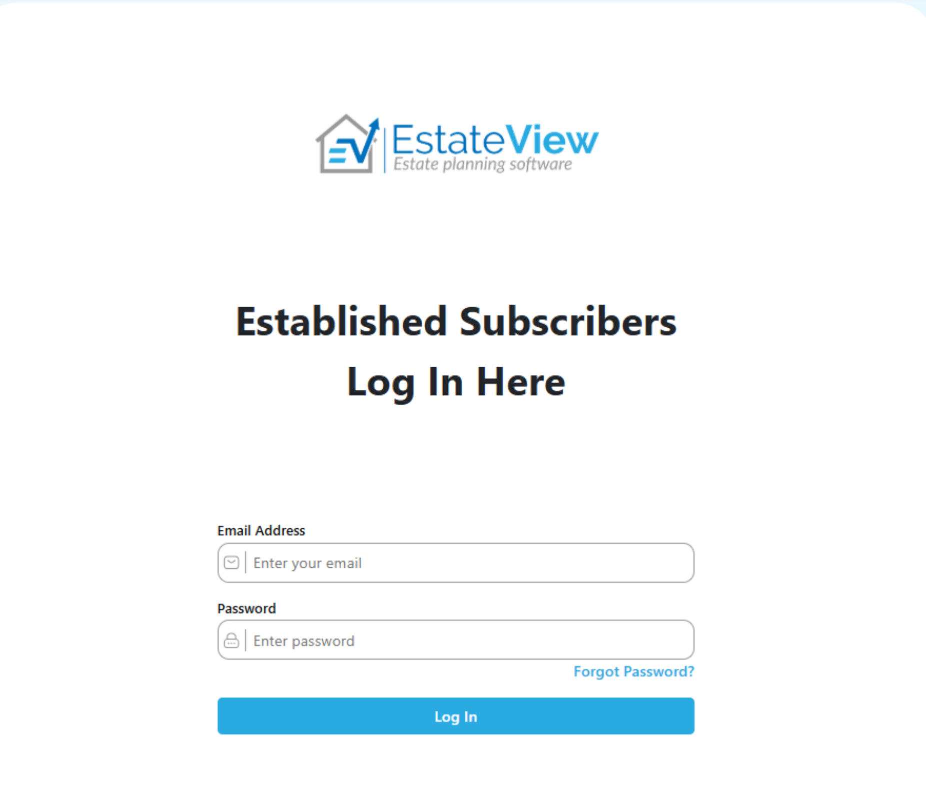

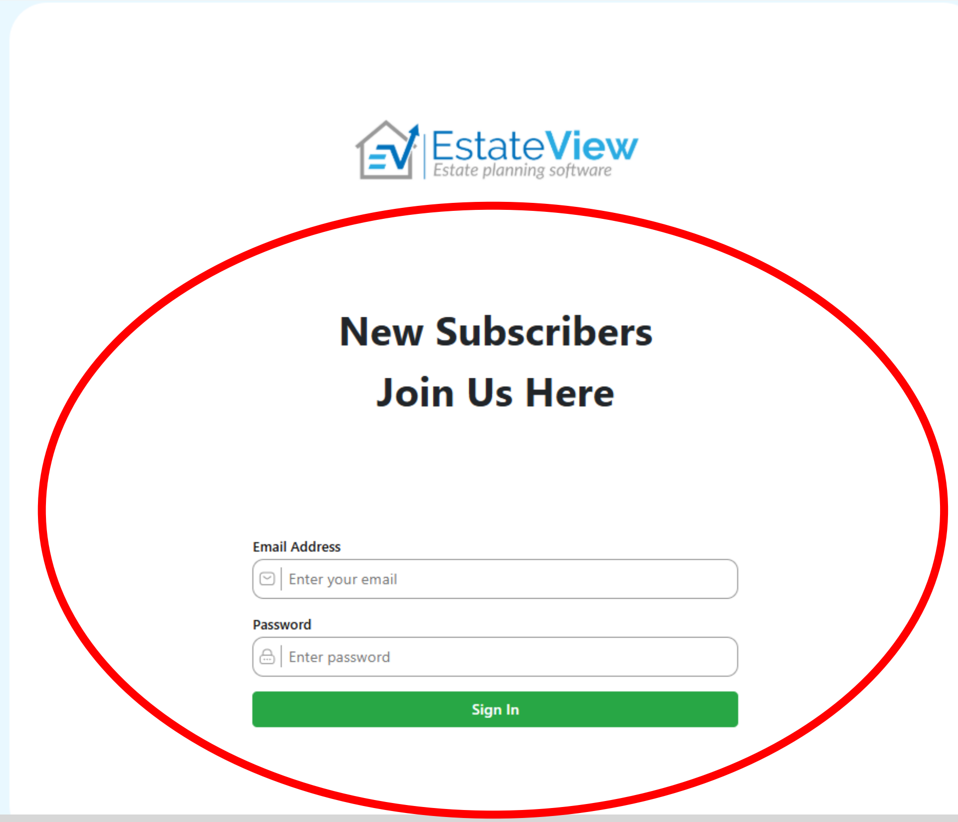

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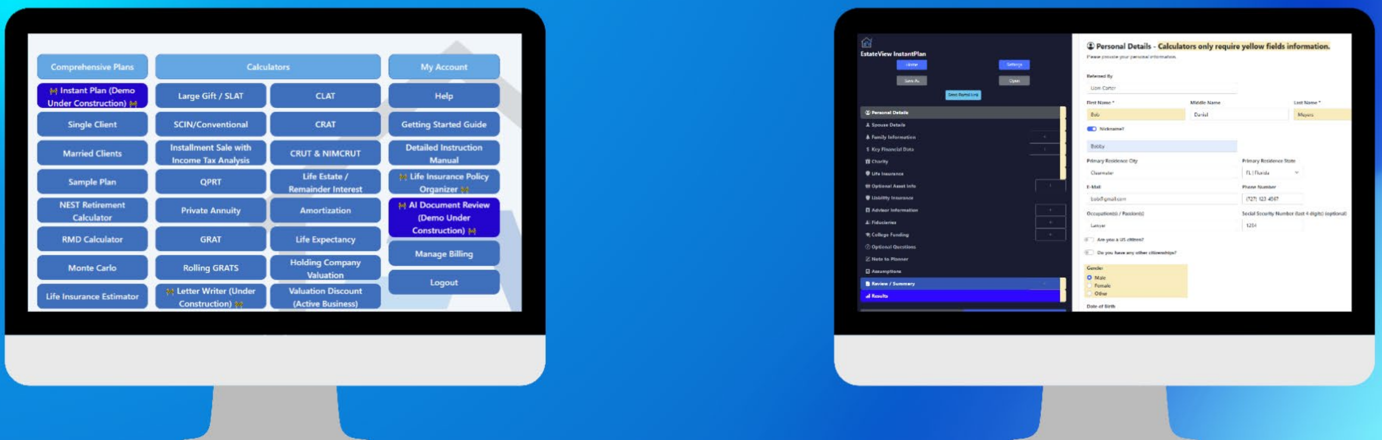

Wednesday, May 21st
12:00 PM ET

Friday, May 23rd
12:00 PM ET

Monday, May 26th
12:00 PM ET

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Friday, May 30th
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Comprehensive Plans	Calculators		My Account
Single Client	Large Gift/SLAT	CLAT	Help
Married Clients	SCIN/Conventional	CRAT	Detailed Instruction Manual
Sample Plan	Installment Sale with Income Tax Analysis	CRUT & NIMCRUT	
NEST Retirement Calculator	QPRT	Life Estate / Remainder Interest	
RMD Calculator	Private Annuity	Amortization	
Monte Carlo	GRAT	Life Expectancy	
Life Insurance Estimator	Rolling GRATs	Holding Company Valuation	
§7520 & AFR Table	Letter Writer (Under Construction)	Valuation Discount (Active Business)	

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What is an Intentionally Defective Grantor Trust?

- IDGT = Intentionally Defective Grantor Trust.
- An irrevocable trust can be disregarded for income tax purposes while it is a completely separate entity for state law and estate and gift tax purposes.
- The Grantor of an IDGT will have the income and deductions of the trust included in his or her personal income tax return.
- The payment of the income tax on trust income is not considered to be a Gift pursuant to Revenue Ruling 2004-64.
- The trust can enter into sales transactions or swap assets and owe money and pay interest to the grantor and none of these transactions will be considered to have occurred for federal income tax purposes pursuant to Revenue Ruling 83-2.

What is an Intentionally Defective Grantor Trust?

- What causes a trust to be disregarded for federal income tax purposes?:
  - A power in the Grantor or any other person to exchange trust assets for assets of equal value.
  - A power in any person or a fiduciary to add beneficiaries to the trust.
- If the Grantor's spouse is a beneficiary and also a trustee in the trust.
- If the Grantor has the power to borrow from the trust without adequate interest <u>or</u> adequate collateral – not safe to use this one – or possibly safe if the interest rate is high enough (If inadequate collateral) or the collateral is strong enough (if inadequate interest) to make it an arms length loan.

What is an Intentionally Defective Grantor Trust?

- What if the Grantor doesn't want to pay income taxes on the trust any longer?:
  - Trust Protectors could change the trust so it is no longer "defective".
  - The Grantor could release the right to swap assets for assets of equal value (if no other Grantor Trust Powers exist).

What is an Intentionally Defective Grantor Trust?

- The trust or state law may give the trustee discretion to reimburse the Grantor for income taxes – for example, Florida law indicates that this possible right to receive reimbursement does not allow creditors to reach into an IDGT.

- Warning Will Robinson – Any Understanding that there will be reimbursement for taxes could cause the trust to be subject to federal estate tax on the death of the Grantor.

- Second Warning Will Robinson – Many Grantors have sued their families and trustees to try to get control back and to try not to pay income taxes – but a trustee does not have a fiduciary duty to the Grantor of an irrevocable trust.

What is a SLAT?

- SLAT = Spousal Limited Access Trust or Spousal Lifetime Access Trust
- An irrevocable trust established by one spouse for the benefit of the other spouse and descendants under which the beneficiary spouse can receive limited distributions during his or her lifetime.
- The trust will not be subject to creditor claims if appropriately drafted.
- Not subject to estate taxes on death of either spouse.

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Terminology

- Grantor Spouse = The spouse who establishes and funds the SLAT.

- Beneficiary Spouse = The spouse that is a beneficiary of the SLAT during both spouses' lifetimes.

The Step Transaction Doctrine

- Spouse 1 and Spouse 2 are married and are each worth $7,500,000.
- Spouse 1 would like to use his or her entire estate tax exemption amount by funding a SLAT.
- Spouse 1 is the primary breadwinner in the family.
- Spouse 2 transfers his or her assets to Spouse 1 so that Spouse 1 can make the gift.
- Will the Step Transaction Doctrine cause one-half of the gift to be considered as having been made by Spouse 2?

The Step Transaction Doctrine

Possible Solutions:

The first transfer occurs in late 2022 and the second transfer occurs in 2025.

Spouse 1 gives Spouse 2 a $7,500,000 promissory note in exchange for the assets and actually pays interest each year. The promissory note is legally binding because Spouse 1 agrees to close all cabinets in the house for at least a month after opening them. **NOTE –** The payment of interest from one spouse to another causes taxable income to be incurred by the recipient, even on a joint income tax return, and the interest will probably not be deductible by the paying spouse. Can Spouse 2 be a beneficiary of a SLAT and split the gift for gift tax purposes in case there is a valuation issue? - Discuss gift splitting and the standard of expectation as to Spouse 2 benefitting from the SLAT.

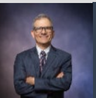
"Use the Ascertainable Standard or a stricter standard and assure that the beneficiary spouse is expected to have access to sufficient resources outside of the trust in question (so that it is highly unlikely that the Trustee would exercise the power and distribute trust property to that spouse)."

See**, "**Qualifying Trust Transfers for Split-Gift Treatment July/August 2007" Florida Bar Journal article by William R. Swindle and Revenue Ruling 56-439, *Robertson v. Commissioner*, 26 T.C.246 (1956), ACQ. 1956-2 C.B. 8, *Wang v. Comissioner,* T.C. Memo 1972-143 and PLR 200345038.

Current and Recent
Applicable Federal Rates (2024-2025)

MONTH	SHORT TERM	MID-TERM	LONG-TERM
June 2024	5.06%	4.61%	4.73%
July 2024	5.00%	4.44%	4.56%
August 2024	4.89%	4.29%	4.47%
September 2024	4.52%	3.98%	4.32%
October 2024	4.17%	3.67%	4.06%
November 2024	3.96%	3.67%	4.11%
December 2024	4.25%	4.14%	4.48%
January 2025	4.28%	4.20%	4.48%
February 2025	4.29%	4.47%	4.80%
March 2025	4.26%	4.41%	4.76%
April 2025	4.12%	4.17%	4.26%
May 2025	4.01%	4.06%	4.57%

Can use lowest of last three months on a "sale or exchange" under IRC Section 1274(d)(2). See IRC Section 7872(f)(2)



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$1,000,000 PROMISSORY NOTE/SCIN/PRIVATE ANNUITY/GRAT ALTERNATIVES

May 2025 / CLIENT AGE 60

Alternatives: (For May 2025 allowable Applicable Federal Rates and May 2025 Section 7520 Rate of 5.0%)

CLIENT
(AGE 70)

TRUST
(PURCHASER)

<3 Year Interest Only Installment Note @ 4.01% - **Payment = $40,100 per year***

9 Year Interest Only Installment Note @ 4.06% - **Payment = $40,600 per year***

>9 Year Interest Only Installment Note @ 4.56% - **Payment = $45,600 per year***

22 Year Interest Only SCIN @ 6.9878% - **Payment = $48,915 per year***

Private Annuity Level Annual Payment - **Payment = $55,210.27 per year**

3 Year Level Payment GRAT @ 5.0% - **Payment = $367,215 per year**

3 Year GRAT @ 5.0% - **Initial Payment = $304,442 and Increases Annually by 20%****

* Notes would have no penalty for prepayment – minimum payments are shown above.

Self-cancelling installment Notes must balloon before life expectancy as measured at time of Note being made. Client's life expectancy is 23 years under IRS tables. The SCIN calculations above are based on a 22-year note term.

** This GRAT assumes that each annuity payment will increase by 20% each year. **All GRATs assume no taxable gift on funding**
If interest rates increase in the future, consider the use of a 20-year interest only note at the 4.56% long-term AFR, locking in a 4.56% rate for the next 20 years.

Note: Lowest allowable semi-annual compounding Applicable Federal Rates for August 2024 are :

Short-Term – 4.01%
Mid-Term – 4.06%
Long-Term – 4.56%

Usable through May 31, 2025 for a "sale or exchange"

$10,000,000 PROMISSORY NOTE/SCIN/PRIVATE ANNUITY ALTERNATIVES
JANUARY 2021
FRED AND WILMA FLINSTONE

ALTERNATIVES: (USING JANUARY 2021 APPLICABLE FEDERAL RATE AND 7520 RATE)

All Notes and the Private Annuity are based on an initial sale amount of $10,000,000

FRED (AGE 66 FOR TAX PURPOSES) ← **TRUST** (PURCHASER)

- 3 Year Interest Only Installment Note @ .14% - **Payment = $14,000 per year***
- 9 Year Interest Only Installment Note @ .52% - **Payment = $52,000 per year***
- 10+ Year Interest Only Installment Note @ 1.35% - **Payment = $135,000 per year***
- 17 Year Interest Only SCIN @ 4.210% - **Payment = $421,000 per year***
- Private Annuity Level Annual Payments - **Payment = $626,532 per year**

* Notes would have no penalty for prepayment - minimum payments are shown above.
Self-Canceling Installment Notes (SCINs) must balloon before life expectancy as measured at time of Note being made. Fred's life expectancy is 17.05 years under IRS tables.
The SCIN calculation above is based on a 17-year note term.

Note: January 2021 rates are:
Short-Term – .14%
Mid-Term -- .52%
Long-Term – 1.35%
} Usable through March 31, 2021
Section 7520 Rate – .6%

ALTERNATIVES: (USING JANUARY 2021 APPLICABLE FEDERAL RATE AND 7520 RATE)

All Notes and the Private Annuity are based on an initial sale amount of $10,000,000

WILMA (AGE 66 FOR TAX PURPOSES) ← **TRUST** (PURCHASER)

- 3 Year Interest Only Installment Note @ .14% - **Payment = $14,000 per year***
- 9 Year Interest Only Installment Note @ .52% - **Payment = $52,000 per year***
- 10+ Year Interest Only Installment Note @ 1.35% - **Payment = $135,000 per year***
- 17 Year Interest Only SCIN @ 4.210% - **Payment = $421,000 per year***
- Private Annuity Level Annual Payments - **Payment = $626,532 per year**

* Notes would have no penalty for prepayment - minimum payments are shown above.
Self-Canceling Installment Notes (SCINs) must balloon before life expectancy as measured at time of Note being made. Wilma's life expectancy is 17.05 years under IRS tables.
The SCIN calculation above is based on a 17-year note term.

Note: January 2021 rates are:
Short-Term – .14%
Mid-Term – .52%
Long-Term – 1.35%
} Usable through March 31, 2021
Section 7520 Rate – .6%

ALTERNATIVES: (USING JANUARY 2021 APPLICABLE FEDERAL RATE AND 7520 RATE)

All Notes and the Private Annuity are based on an initial sale amount of $10,000,000

FRED & WILMA, jointly ← **TRUST** (PURCHASER)

- 3 Year Interest Only Installment Note @ .14% - **Payment = $14,000 per year***
- 9 Year Interest Only Installment Note @ .52% - **Payment = $52,000 per year***
- 10+ Year Interest Only Installment Note @ 1.35% - **Payment = $135,000 per year***
- 21 Year Interest Only SCIN @ 3.205% - **Payment = $320,500 per year***
- Private Annuity Level Annual Payments - **Payment = $502,690 per year**

* Notes would have no penalty for prepayment - minimum payments are shown above.
Self-Canceling Installment Notes (SCINs) must balloon before life expectancy as measured at time of Note being made. Fred & Wilma's joint life expectancy is 21.96 years under IRS tables.
The SCIN calculation above is based on a 21-year note term.

Note: January 2021 rates are:
Short-Term -- .14%
Mid-Term – .52%
Long-Term -- 1.35%
} Usable through March 31, 2021
Section 7520 Rate – .6%

Using the SCIN strategy:

- A Self-Canceling Installment Note (SCIN) is often used for Promissory Notes between family members.

- Ideally, the Payee dies before the Note is fully repaid (the family is happier this way!), and any remaining balance is forgiven upon death. Thus, the value is not included in the Payee's estate.

- However, the IRS takes the position that a SCIN can only be entered into if the Payee is in reasonable health, and is generally expected to live to the normal expectancy.

- The forgiveness feature is not considered to be a gift when:
  - The Note is subject to a premium interest rate (in excess of the AFR) - OR
  - if the required interest rate would be usurious, then a premium is added to
  - the Note's principal at its inception.

Using the SCIN strategy (continued):

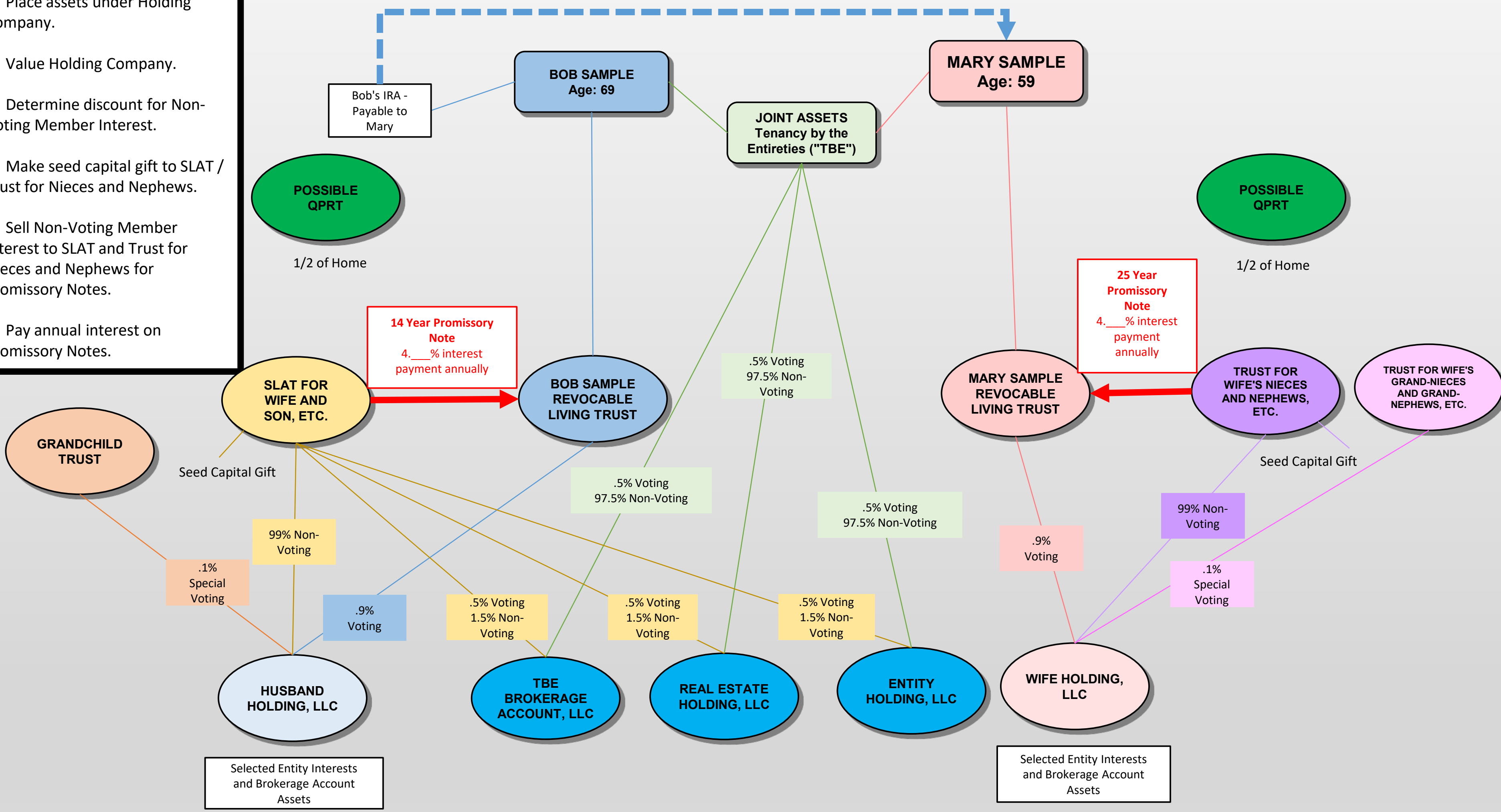
- It is crucial that note payments be made on a timely basis.
- Failure to make timely payments gives the IRS ammunition to deem the indebtedness as illusory.
- It is also normally recommended that the note be secured by collateral or other guarantors.

Sale #	Grantor Age	2nd Life Age	Life Expec-tancy	Year of Death	Term of Note	Annual Growth Rate	Year One Gift	Value Before Discounts	Value After Discounts	Note Type	Payment Type	Note Amount	Interest Rate Risk Premium	Interest Rate With Premium	Annual Payment	Total Estate Tax Savings
1	70	N/A	15.4	15	15	7.50%	$100,000	$1,000,000	$1,000,000	SCIN	Interest Only	$1,000,000	4.1213%	8.6813%	$86,813	$1,231,328

Installment Sales to Intentionally Defective Grantor Trusts

ESTATE TAX / CREDITOR PROTECTION FOR BOB AND MARY

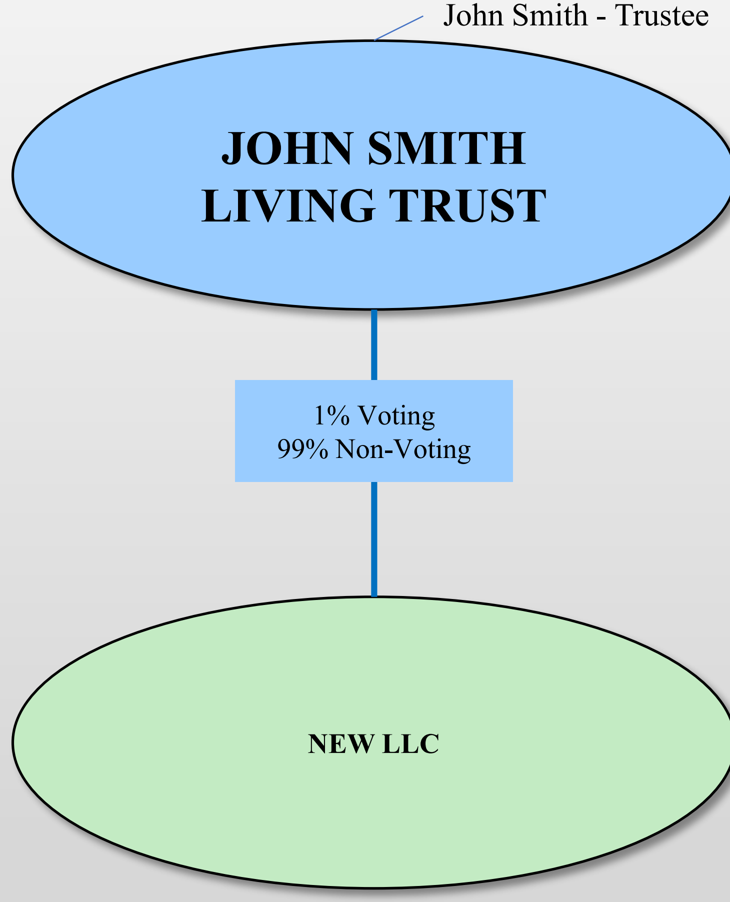
1. Place assets under Holding Company.
2. Value Holding Company.
3. Determine discount for Non-Voting Member Interest.
4. Make seed capital gift to SLAT / Trust for Nieces and Nephews.
5. Sell Non-Voting Member Interest to SLAT and Trust for Nieces and Nephews for Promissory Notes.
6. Pay annual interest on Promissory Notes.



Typical Investment Portfolio Installment Sale

Step 1:

- Form a new LLC.
- John Smith Living Trust will own 1% Voting Membership Interest and a 99% Non-Voting Membership Interest in the New LLC.
- The new LLC will have $ 10,000,000 worth of equities and bonds.



Investments (Equities and Bonds): $10,000,000

Step 2:

- Form a Spousal Limited Access Trust (“SLAT”).
- Jane Smith and Mary Taylor will be the Co-Trustee of the SLAT.
- The SLAT will open a $10,000 Nevada Account to be signed on by Mary Taylor and maybe a Nevada-based Merrill Lynch account.
- Jane Smith will sign on an account under the SLAT at Merrill Lynch that will receive a $700,000 seed capital gift of stocks and bonds.

Jane Smith & Mary Taylor-
Co-Trustees

SMITH SPOUSAL LIMITED ACCESS TRUST

Nevada Account: $10,000
(Mary as signor)

Nevada Merrill Lynch Account (may open)

Seed Capital Gift : $700,000 of stocks and bonds
(Jane as signor)

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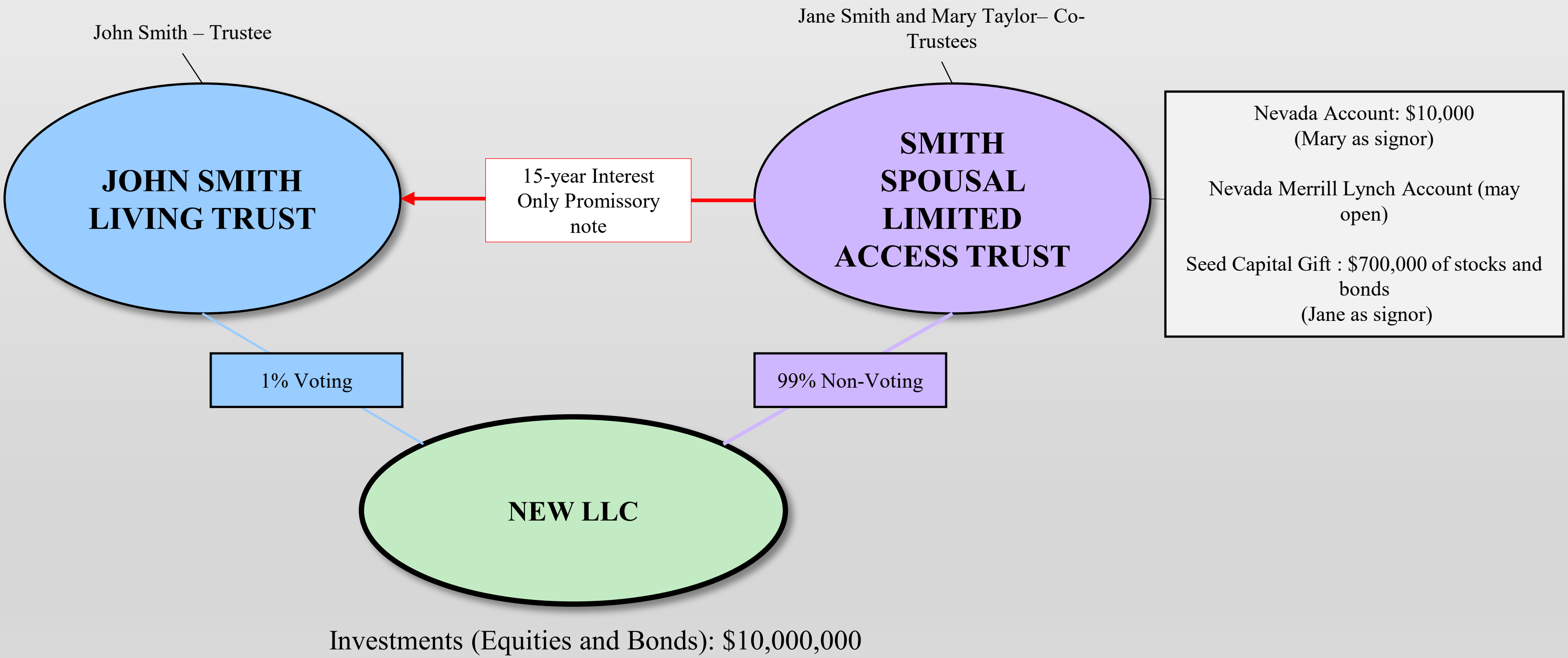
Step 3:

- Jane Smith and Mary Taylor, as Co-Trustees, buy the 99% Non-Voting Membership Interest in new LLC in exchange for a 15-year interest only promissory note bearing interest at the long-term applicable federal rate, paying interest of approximately $300,000 a year to John Smith.
- Each year, stocks and bonds worth the amount of interest owed will be transferred from SLAT to John Smith as payments.
- Eventually, the new LLC will start making pro rata distributions 99% to the SLAT account signed on by Jane and 1% to John to enable him to make the interest payments.



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GASSMAN CROTTY & DENICOLO, P.A.
ATTORNEYS AT LAW

Dear John and Jane:

More correspondence is coming, but I wanted to reiterate what we discussed about an installment sale based upon example numbers indicated below.

We will form a new LLC that you will give us a name for.

The Smith Living Trust will own a 99% Non-Voting Membership Interest and 1% Voting Membership Interest in the new LLC.

The new LLC will have $10,000,000 worth of equities and bonds.

We will form a Spousal Limited Access Trust ("SLAT") and Jane and Mary Taylor will serve as Co-Trustees.

The SLAT will open a $10,000 Nevada account to be signed on by Mary and may also open a Nevada-based Merrill Lynch account.

The SLAT will also open a Merrill Lynch account to be signed on by Jane that will receive a $700,000 seed capital gift of stocks and bonds.

Jane and Mary, as Co-Trustees of the SLAT will buy the 99% Non-Voting Membership Interest in the new LLC in exchange for a 15 year interest only Promissory Note bearing interest at the long-term applicable federal rate, paying interest of approximately $300,000 to the John Smith Living Trust.

Each year stocks and bonds worth the amount of interest owed will be transferred from the SLAT to the John Smith Living Trust as payments.

The SLAT and LLC can be disregarded for income tax purposes so that all of the dividends, interest and capital gains income can go on your Form 1040 income tax return, with the tax being paid from personal assets to further reduce your estates.

Eventually, the new LLC will start making pro rata distributions 99% to the SLAT account that is signed on by Ellen and 1% to the John Smith Living Trust to enable you to make the interest payments.

I am enclosing an illustration chart that also explains the above.

I welcome any questions, comments or suggestions on the above and attached.

Best personal regards,

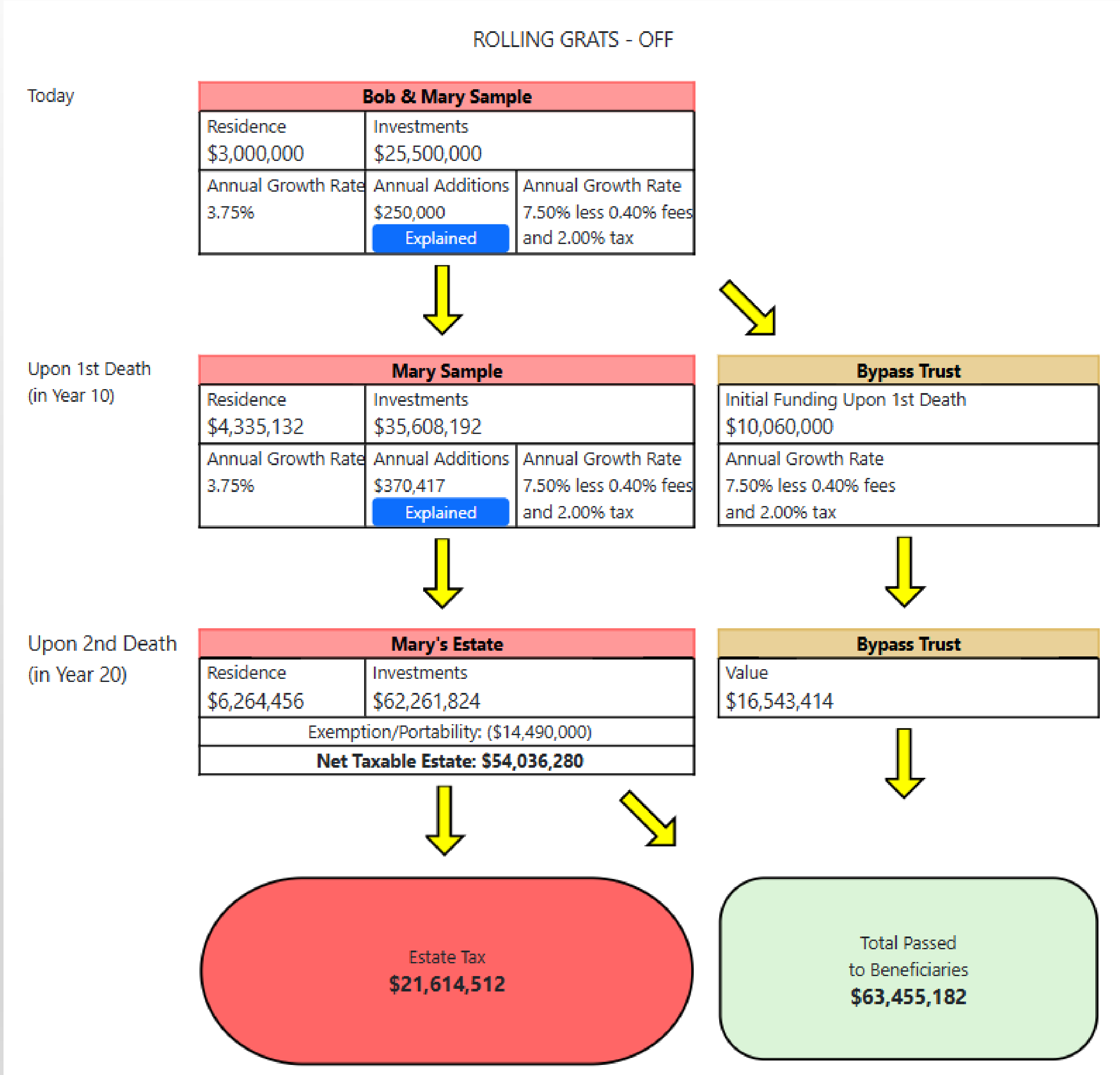
VIA EMAIL

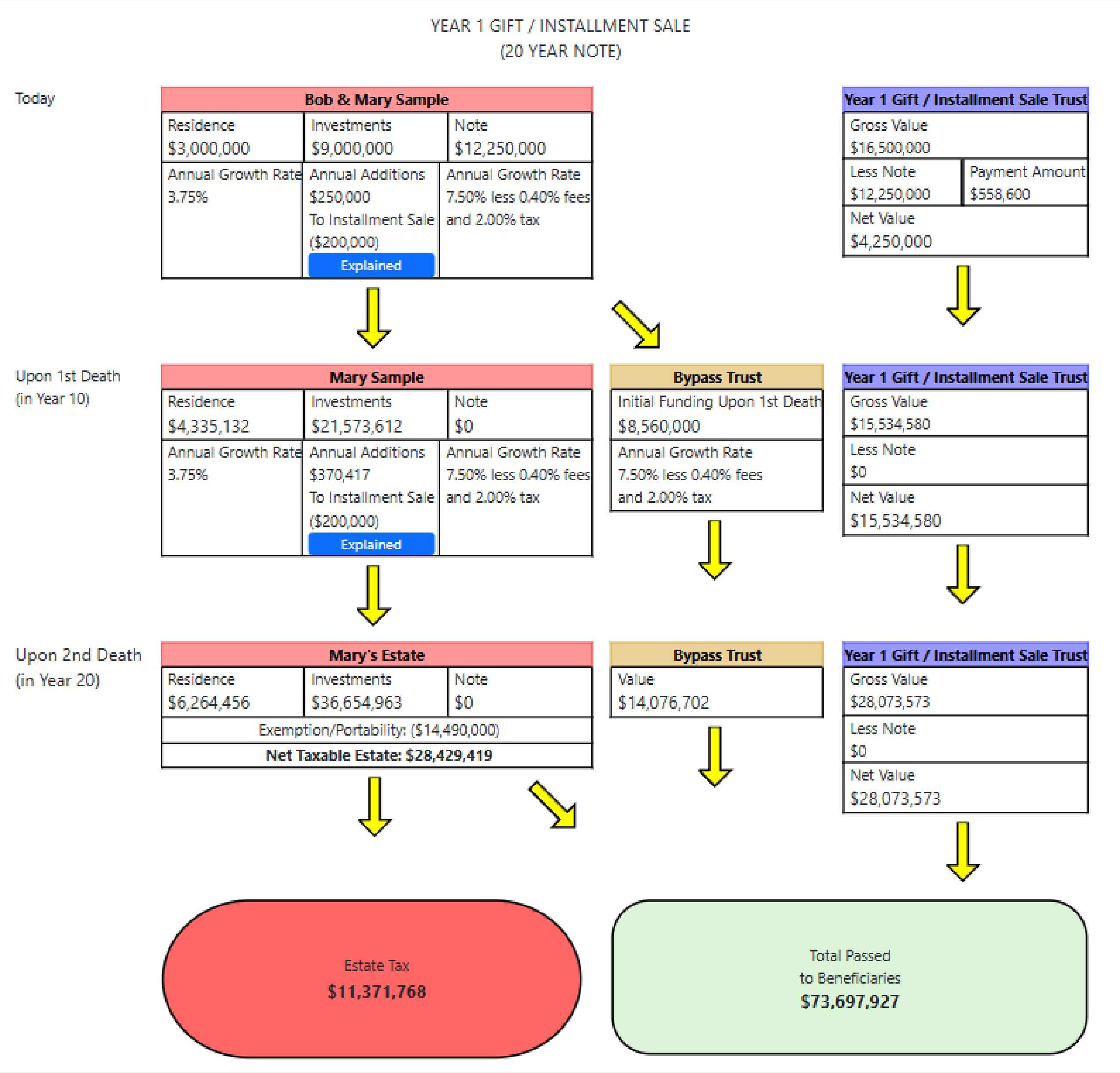
Alan S. Gassman

Installment Sale / Year 1 Gift to Irrevocable Trust	Will Show If Checked: ☑
Grantor of Trust	Spouse 1
Year One Gift — Lock to 10%? ☑	$1,500,000
Year One Gift Discount Rate	0.00%
Year One Gift after Discount	$1,500,000
Sale Value before Discount	$15,000,000
Discount Rate	30.00%
Sale Value after Discount	$10,500,000
Add Explosive Asset? (in addition to above)	☐
Total Sale Value	**$10,500,000**
Note Amount	$12,250,000
Note Interest Rate — Look Up AFR	4.56%

Best to use lowest rate.		
Mar	Apr	May
4.76%	4.56%	4.57%

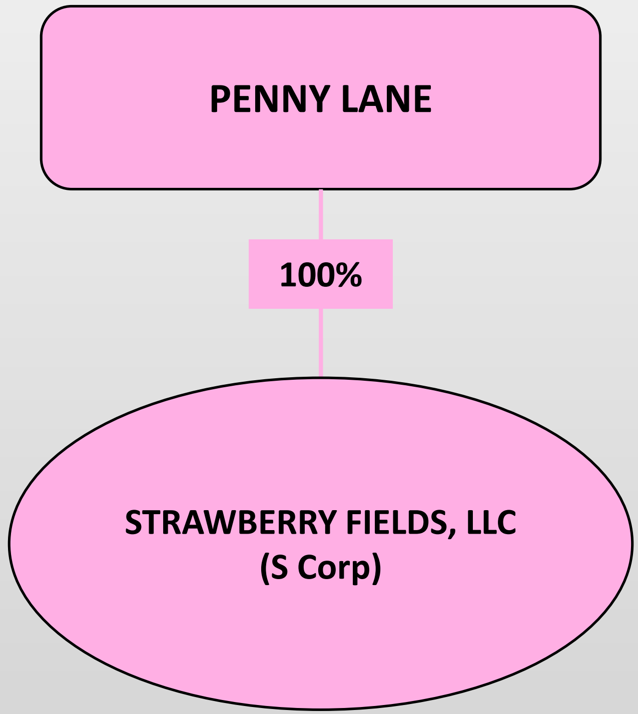
Type of Note	Conventional
Note Payment Amount	$558,600
Note Term in Years	20
Year to Toggle Off Grantor Status	Never
Additional Income to Installment Sale Trust	$200,000
Number of Years of Additional Income	30
Will the Note be Discounted on Death?	☐
Guarantee Fee?	☐


ROLLING GRATS - OFF
Today
Bob & Mary Sample
Residence
$3,000,000
Investments
$25,500,000
Annual Growth Rate
3.75%
Annual Additions
$250,000
Explained
Annual Growth Rate
7.50% less 0.40% fees
and 2.00% tax
Upon 1st Death
(in Year 10)
Mary Sample
Residence
$4,335,132
Investments
$35,608,192
Annual Growth Rate
3.75%
Annual Additions
$370,417
Explained
Annual Growth Rate
7.50% less 0.40% fees
and 2.00% tax
Bypass Trust
Initial Funding Upon 1st Death
$10,060,000
Annual Growth Rate
7.50% less 0.40% fees
and 2.00% tax
Upon 2nd Death
(in Year 20)
Mary's Estate
Residence
$6,264,456
Investments
$62,261,824
Exemption/Portability: ($14,490,000)
Net Taxable Estate: $54,036,280
Bypass Trust
Value
$16,543,414
Estate Tax
$21,614,512
Total Passed
to Beneficiaries
$63,455,182


YEAR 1 GIFT / INSTALLMENT SALE
(20 YEAR NOTE)
Today
Bob & Mary Sample
Residence
$3,000,000
Investments
$9,000,000
Note
$12,250,000
Annual Growth Rate
3.75%
Annual Additions
$250,000
To Installment Sale
($200,000)
Explained
Annual Growth Rate
7.50% less 0.40% fees
and 2.00% tax
Year 1 Gift / Installment Sale Trust
Gross Value
$16,500,000
Less Note
$12,250,000
Payment Amount
$558,600
Net Value
$4,250,000
Upon 1st Death
(in Year 10)
Mary Sample
Residence
$4,335,132
Investments
$21,573,612
Note
$0
Annual Growth Rate
3.75%
Annual Additions
$370,417
To Installment Sale
($200,000)
Explained
Annual Growth Rate
7.50% less 0.40% fees
and 2.00% tax
Bypass Trust
Initial Funding Upon 1st Death
$8,560,000
Annual Growth Rate
7.50% less 0.40% fees
and 2.00% tax
Year 1 Gift / Installment Sale Trust
Gross Value
$15,534,580
Less Note
$0
Net Value
$15,534,580
Upon 2nd Death
(in Year 20)
Mary's Estate
Residence
$6,264,456
Investments
$36,654,963
Note
$0
Exemption/Portability: ($14,490,000)
Net Taxable Estate: $28,429,419
Bypass Trust
Value
$14,076,702
Year 1 Gift / Installment Sale Trust
Gross Value
$28,073,573
Less Note
$0
Net Value
$28,073,573
Estate Tax
$11,371,768
Total Passed
to Beneficiaries
$73,697,927

Strawberry Installment Sale Of Profitable S Corporation Forever

BEFORE PLANNING



Value	**$10,000,000**
Annual Income	**$2,000,000**

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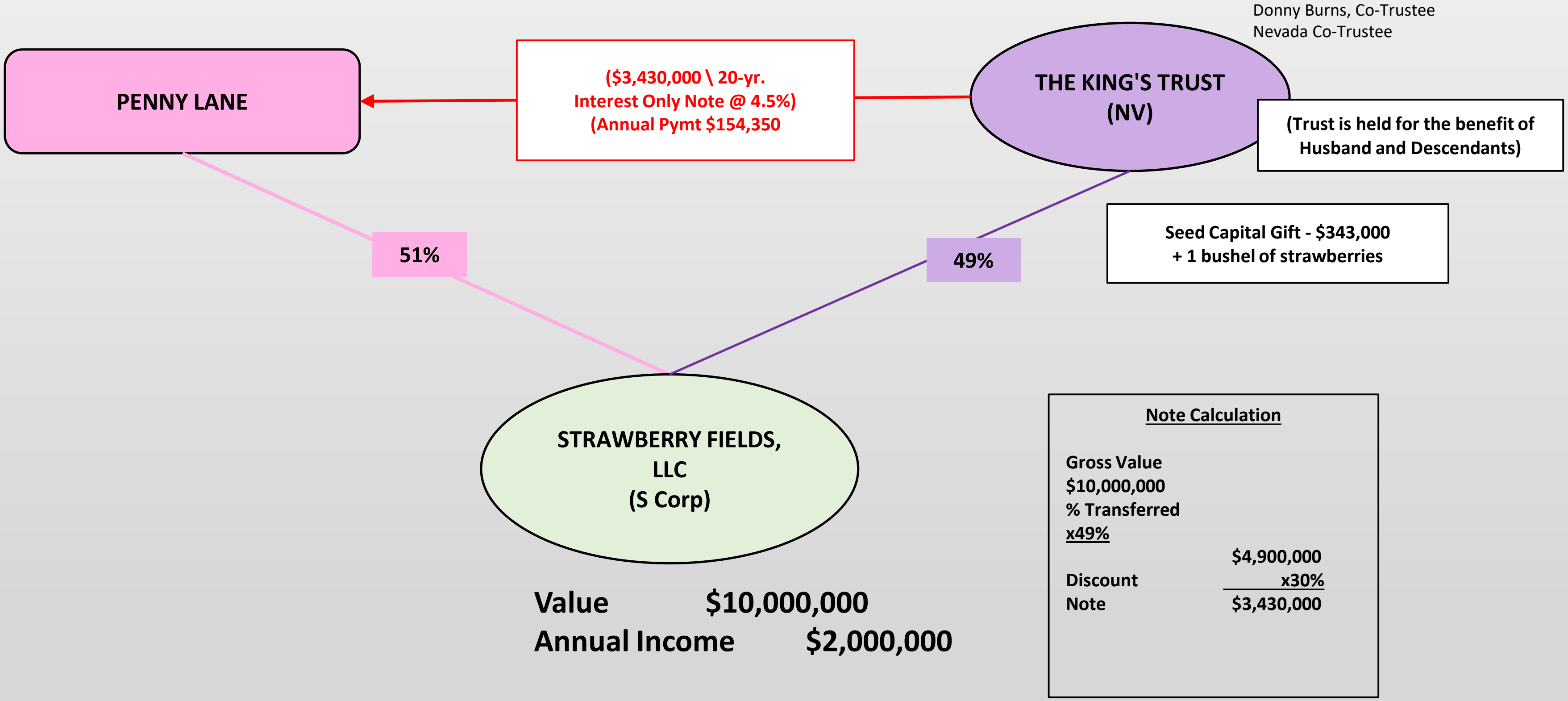
AFTER PLANNING



TEN YEARS AFTER [1]

Donny Burns, Co-Trustee
Nevada Co-Trustee

PENNY LANE

($3,430,000 \ 20-yr.
Interest Only Note @ 4.5%)
(Annual Pymt $154,350

THE KING'S TRUST (NV)

(Trust is held for the benefit of Husband and Descendants)

51%

49%

Penny's Yearly Dividend	$1,020,000
Income Tax Paid	($800,000)
Net	$220,000
Note Payment Rec'd	$154,350
TOTAL:	$374,350

Penny receives $1,020,000 each year as dividends.

She pays income tax of $800,000 for a net of $220,000.

She receives the note payment of $154,350 for a total of $374,350, instead of receiving $1,454,250/year

STRAWBERRY FIELDS, LLC (S Corp)

Value $10,000,000
Annual Income $2,000,000

Annual Trust Cash Flow

Stock in Strawberry Fields, LLC	$980,000
Note Payment	($154,350)
Net Cash Flow	$825,650

Trust Balance Sheet

Stock in Strawberry Fields, LLC	$9,800,000
Assets:	
Value of Invested Cash Flow at 7% after 10 years	$11,407,550
	$21,207,550
Liabilities:	
(Note Payable)	($3,430,000)
Net Equity	$17,777,550
TOTAL ESTATE TAX SAVINGS YEAR 10	$7,111,020

[1] Greatest hit from the band: I'd Love to Change the World (1971)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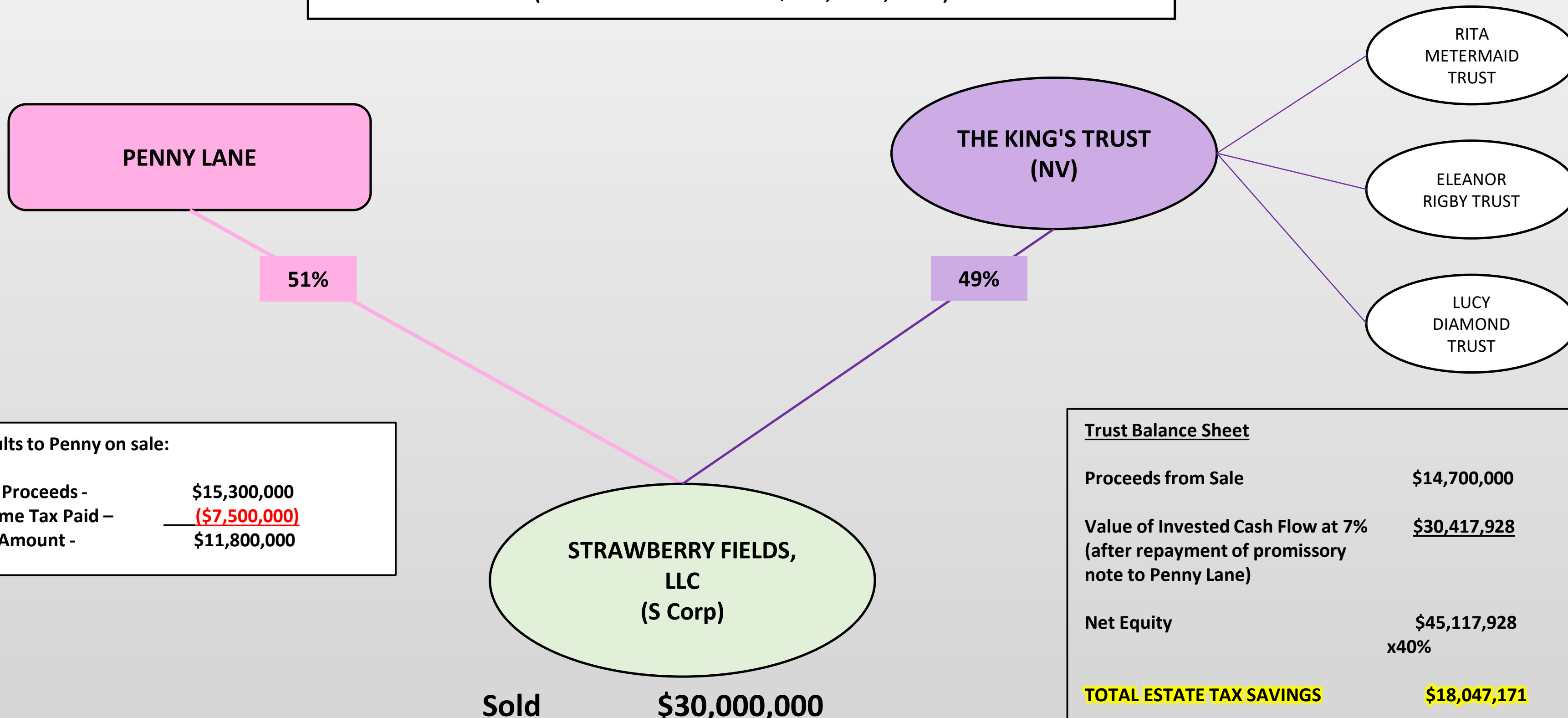
AFTER PLANNING – TWENTY YEARS LATER
(Business Sells for $30,000,000)

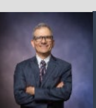


Results to Penny on sale:

Sale Proceeds -	**$15,300,000**
Income Tax Paid –	**($7,500,000)**
Net Amount -	**$11,800,000**

Trust Balance Sheet

Proceeds from Sale	**$14,700,000**
Value of Invested Cash Flow at 7% (after repayment of promissory note to Penny Lane)	**$30,417,928**
Net Equity	**$45,117,928**
	x40%
TOTAL ESTATE TAX SAVINGS	**$18,047,171**



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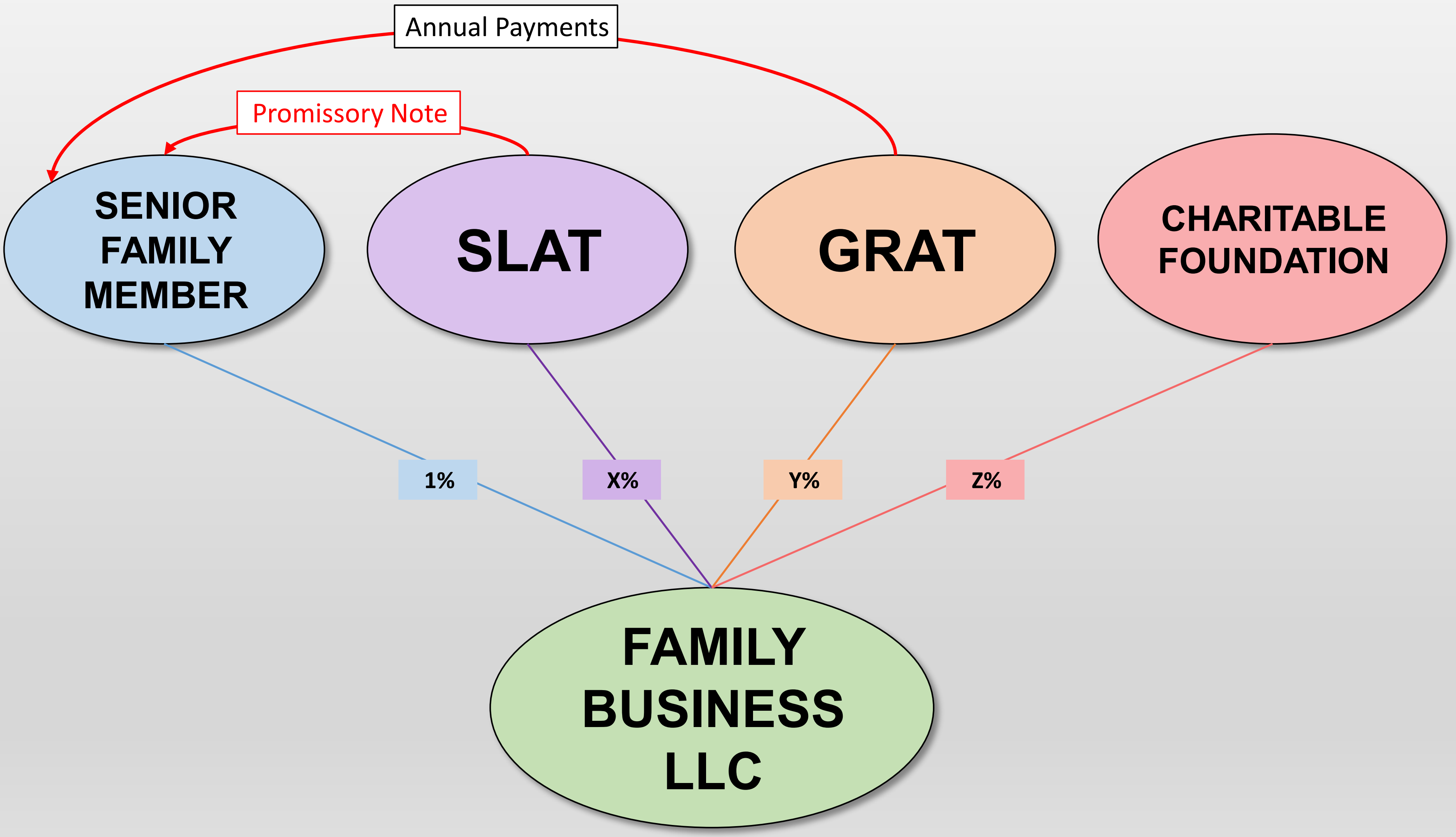
Too Big For Installment Sale



The Story of Morey and Leslie

- The Section 7520 rate at the time of their planning is 5% and the long term applicable federal rate for the month of their planning (June 2024) is 4.73%, with the May rate having been 4.5% an the April rate having been 4.4%, so that they can use a 4.4% rate on an installment sale.
- Their children are self supporting and self reliant but they want to make sure that they provide a good amount for their future benefit, while also minimizing the assets in their estate when they pass.
- They both are healthy and health-conscious and expect to live slightly longer than the IRS tables project for a married couple of ages 68 and 64.

Person 1 Age	Person 1 Life Expectancy	Person 2 Age	Person 2 Life Expectancy	Survivor Life Expectancy
68	16.8 (age 84.8)	64	19.8 (age 83.8)	23.4 (ages 91.4/87.4)

- We assume inflation will average 3.71% per year and the estate tax rate is 40% and the exemption will drop by 50% on Jan. 1, 2026.
- The following charts show possible math outcomes based upon the above assumptions.

No Planning

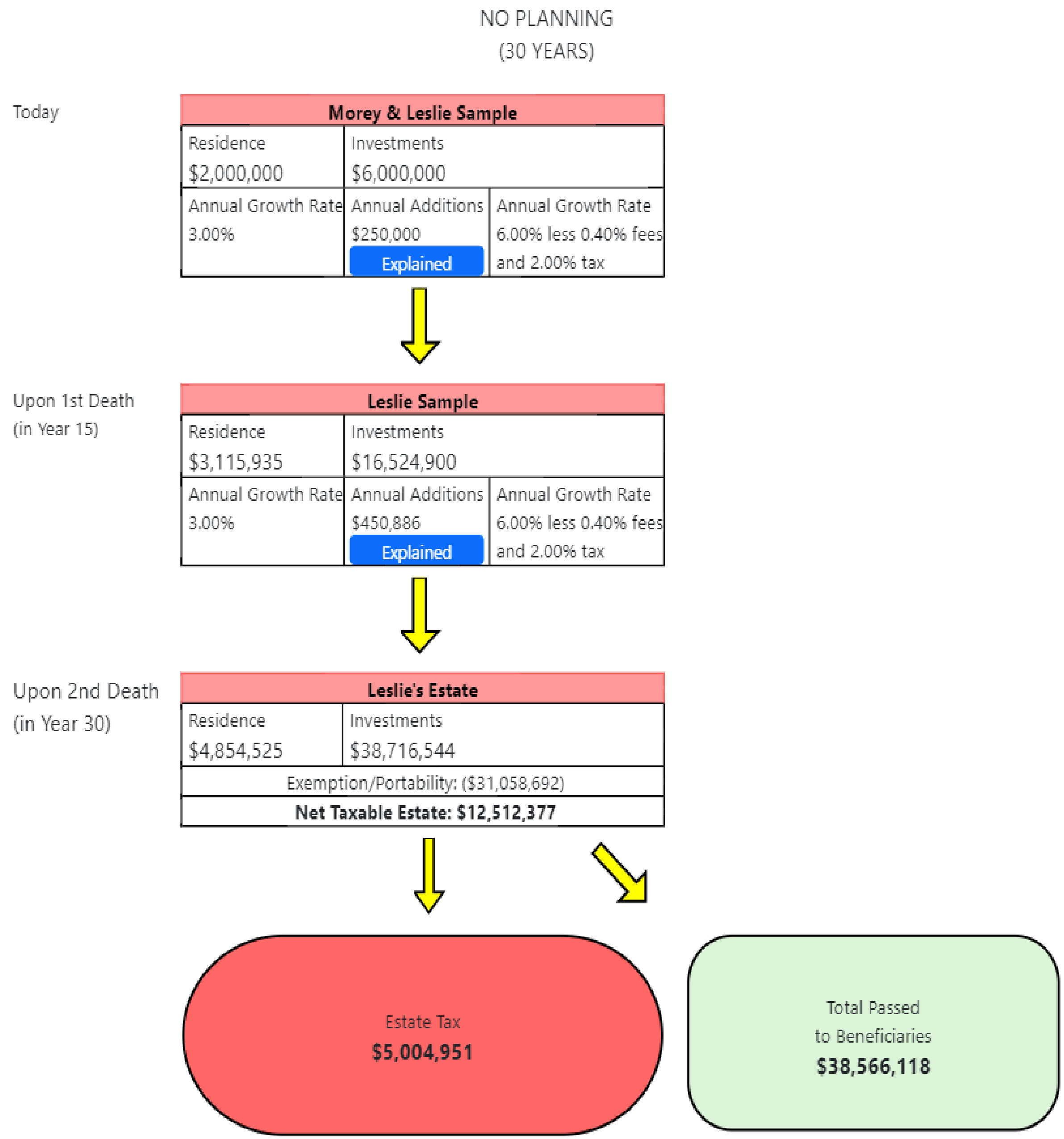
Morey Dies (Year 15)
Leslie Dies (Year 30)

- Morey and Leslie own a $2m personal residence growing at 3% per year net of expenses.

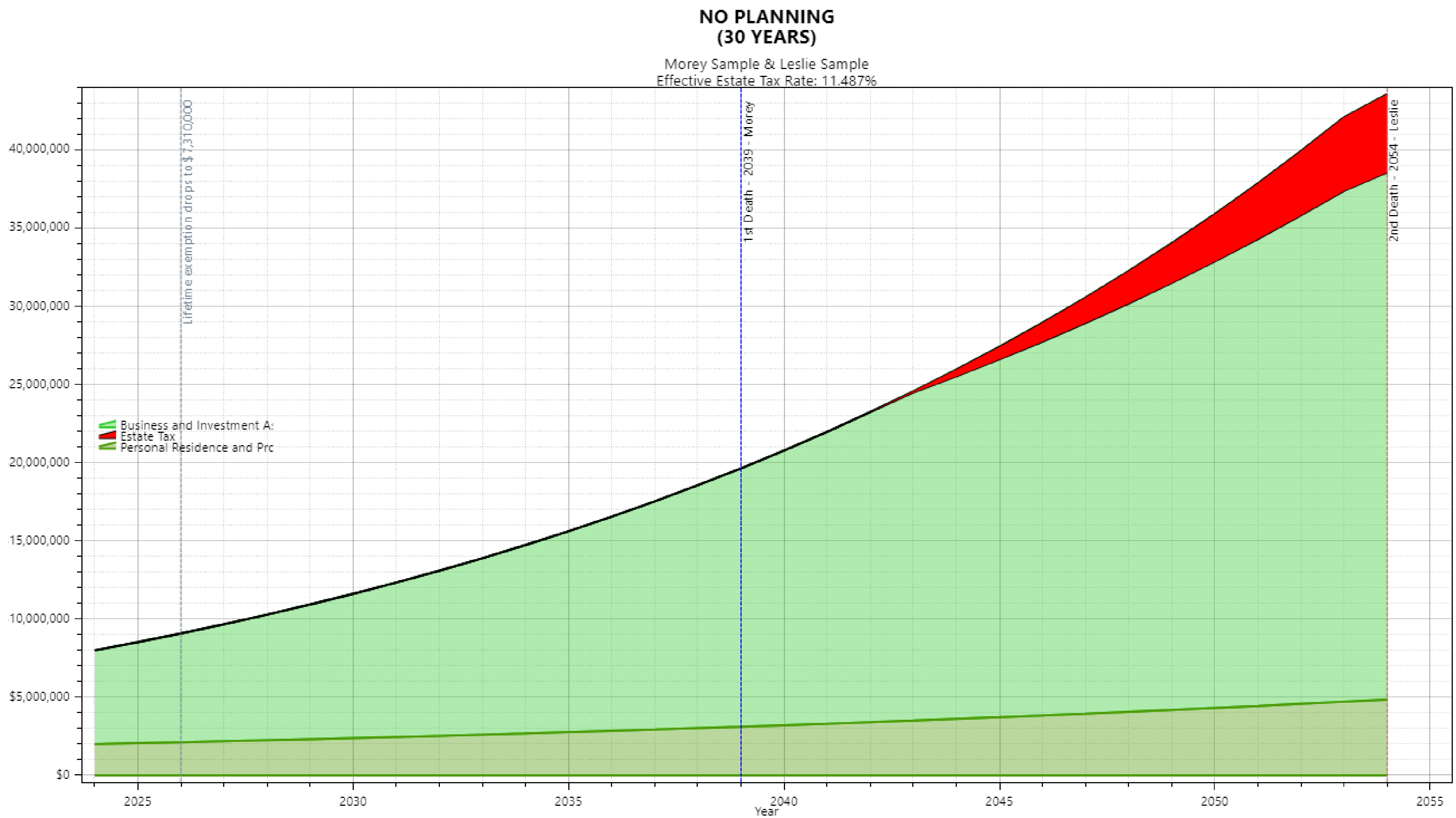
- They have $6m in investment assets growing at 6% per year, minus 2.4% for taxes and fees (3.6% net investment growth rate).

- They save $250,000 per year until 30 years and are ages 68 and 64. We ran the numbers for their deaths in years 15 and 30.

- Estate tax (No planning) = $5m of estate tax.



No Planning


NO PLANNING
(30 YEARS)
Morey Sample & Leslie Sample
Effective Estate Tax Rate: 11.487%
Lifetime exemption drops to $ 7,310,000
1st Death - 2039 - Morey
2nd Death - 2054 - Leslie
Business and Investment A:
Estate Tax
Personal Residence and Prc
40,000,000
35,000,000
30,000,000
25,000,000
20,000,000
15,000,000
10,000,000
$5,000,000
$0
2025
2030
2035
2040
2045
2050
2055
Year

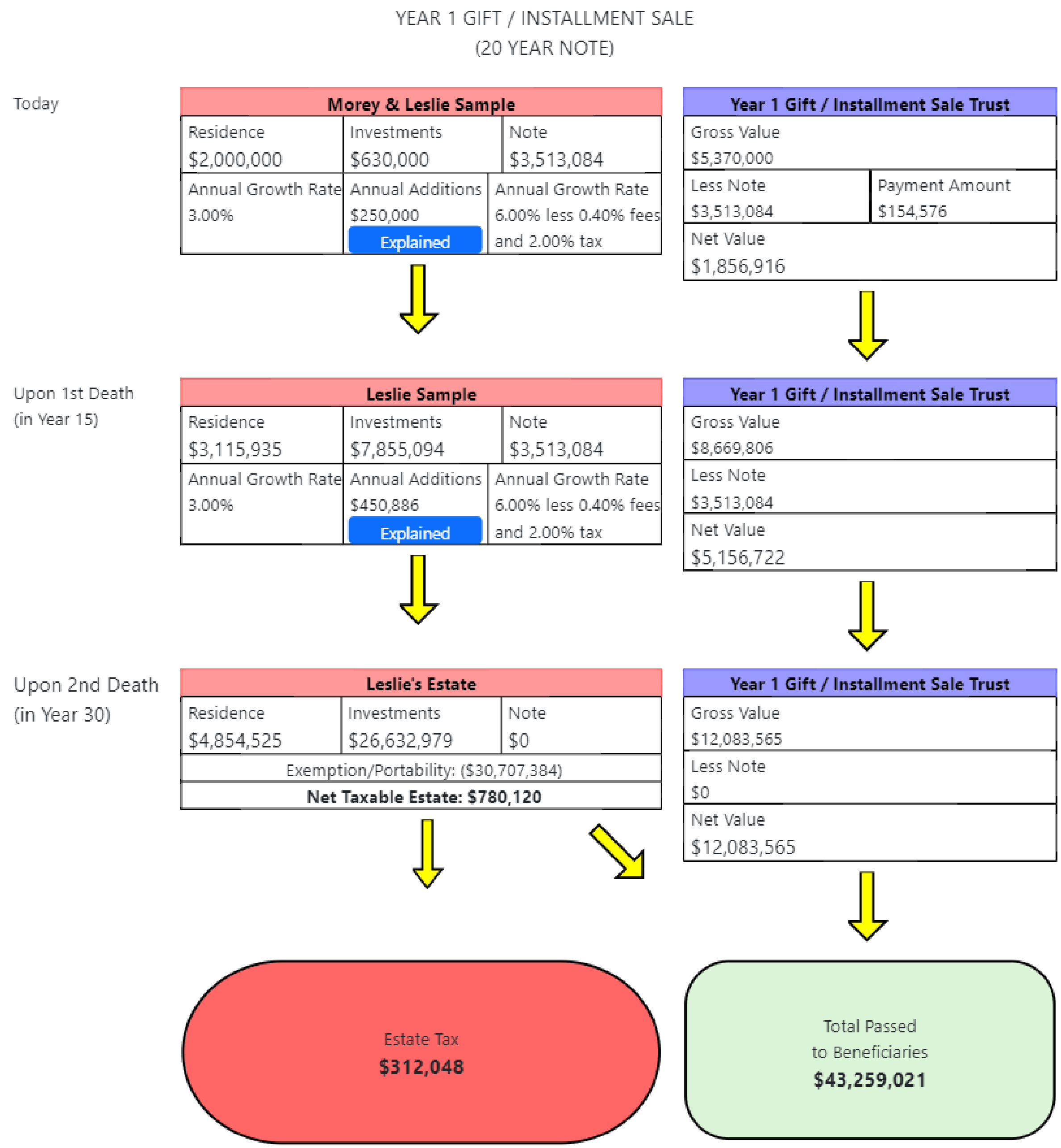
Installment Sale

Morey Dies (Year 15)
Leslie Dies (Year 30)

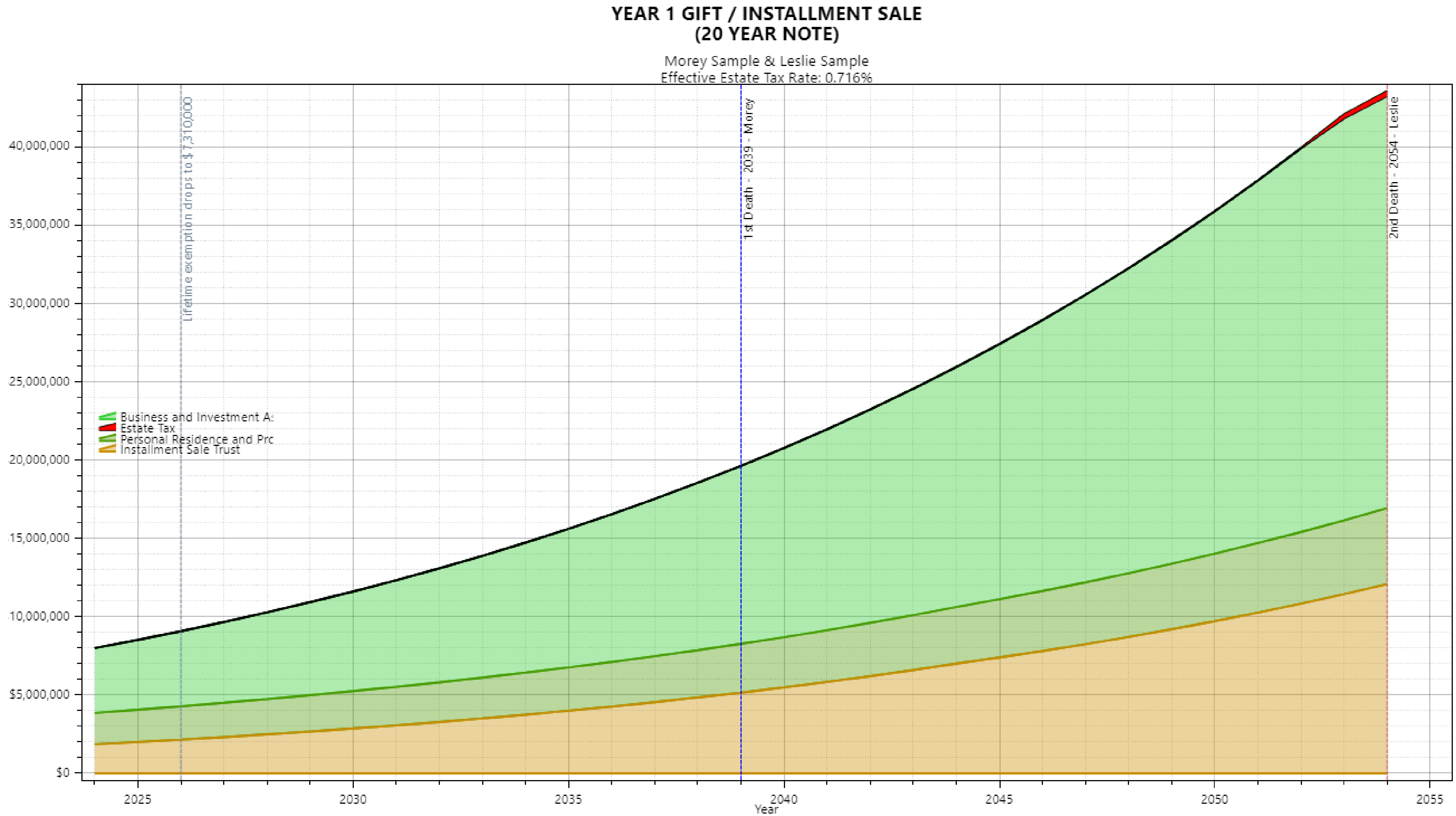
- Morey and Leslie make a gift of $351,308 directly to an irrevocable trust and transfer $5,018,692 to an LLC. They then sell the 99% non-voting member interest in the LLC to the trust in exchange for a 20 year $3,513,084 note bearing interest at 4.4% payable annually - $154,576 per year.

- The difference in the value of the transfer to the LLC and the value of the note is due to a 30% discount on the business interest due to lack of marketability and lack of control.

- Estate tax (no planning) = $5m
  Estate tax (Installment Sale) = $300k

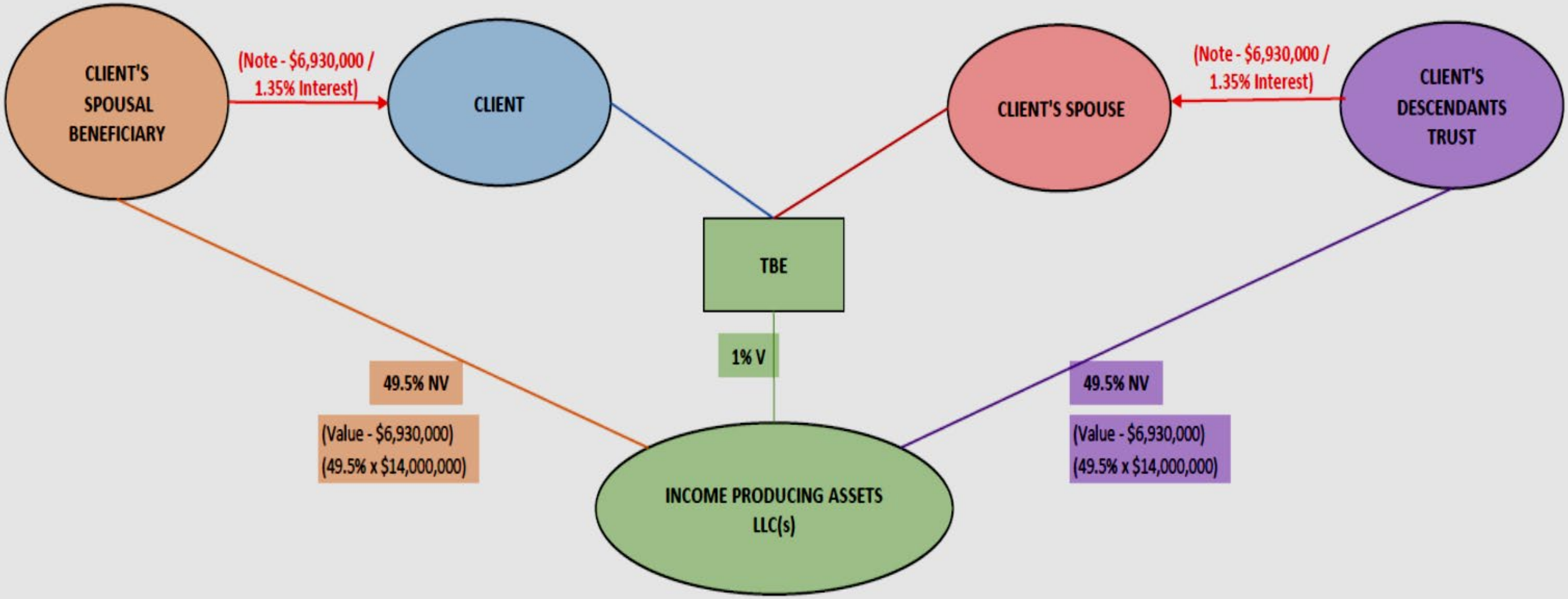


Installment Sale



Second Installment Sale Demonstration – Investment Assets That Will Double In Value Over 10 Years

Installment Sale (1 Of 2)



Value	$20,000,000
Discounted Value	$14,000,000

***NOTE:** A separate trust for children may own a 1/10th of 1% Special Voting Member Interest that allows the Trustee of that trust to control if and when the LLC will make a distribution

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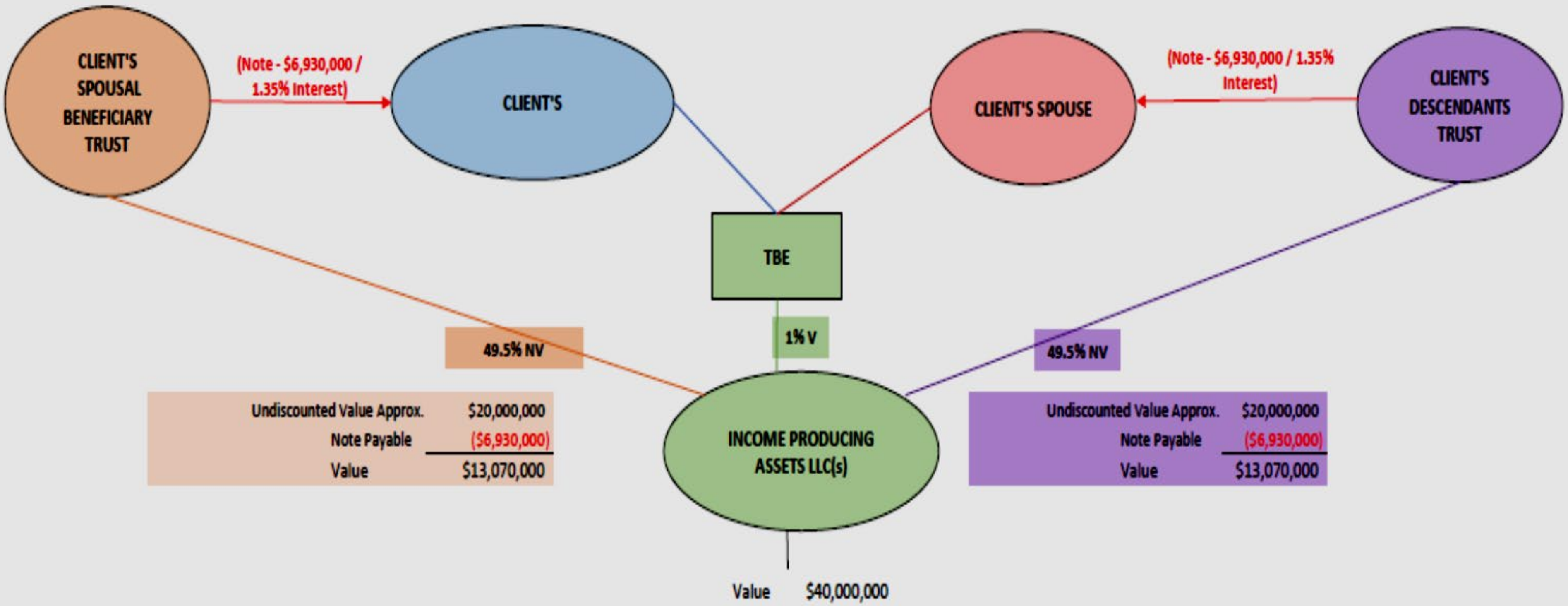
Installment Sale – 10 Years Later (2 Of 2)



*NOTE: A separate trust for children may own a 1/10th of 1% Special Voting Member Interest that allows the Trustee of that trust to control if and when the LLC will make a distribution

Third Installment Sale Demonstration for a profitable S Corporation

When Part Ownership of an Active Business Is Involved . . .

. . . the numbers can be very advantageous.

Assume, for example, that an S corporation receives $10,000,000 a year of net income and is valued at $60,000,000.

40% of the Company may be worth $18,000,000 (40% x $60,000,000 x 66.23% - Valuation Discount of 33 1/3%).

If the 40% interest is transferred in exchange for a $18,000,000 promissory note bearing interest at 1%, the following may occur:

1. Each year, the trust that has purchased the 40% interest will receive $4,000,000.

2. Each year, the trust will pay the Seller $180,000 in interest.

3. After 5 years, the Trust has $20,000,000, plus whatever it has earned thereon, and owes only $1,800,000.

   It also owns 40% of the Company!

When Part Ownership of an Active Business Is Involved . . . (Cont'd)

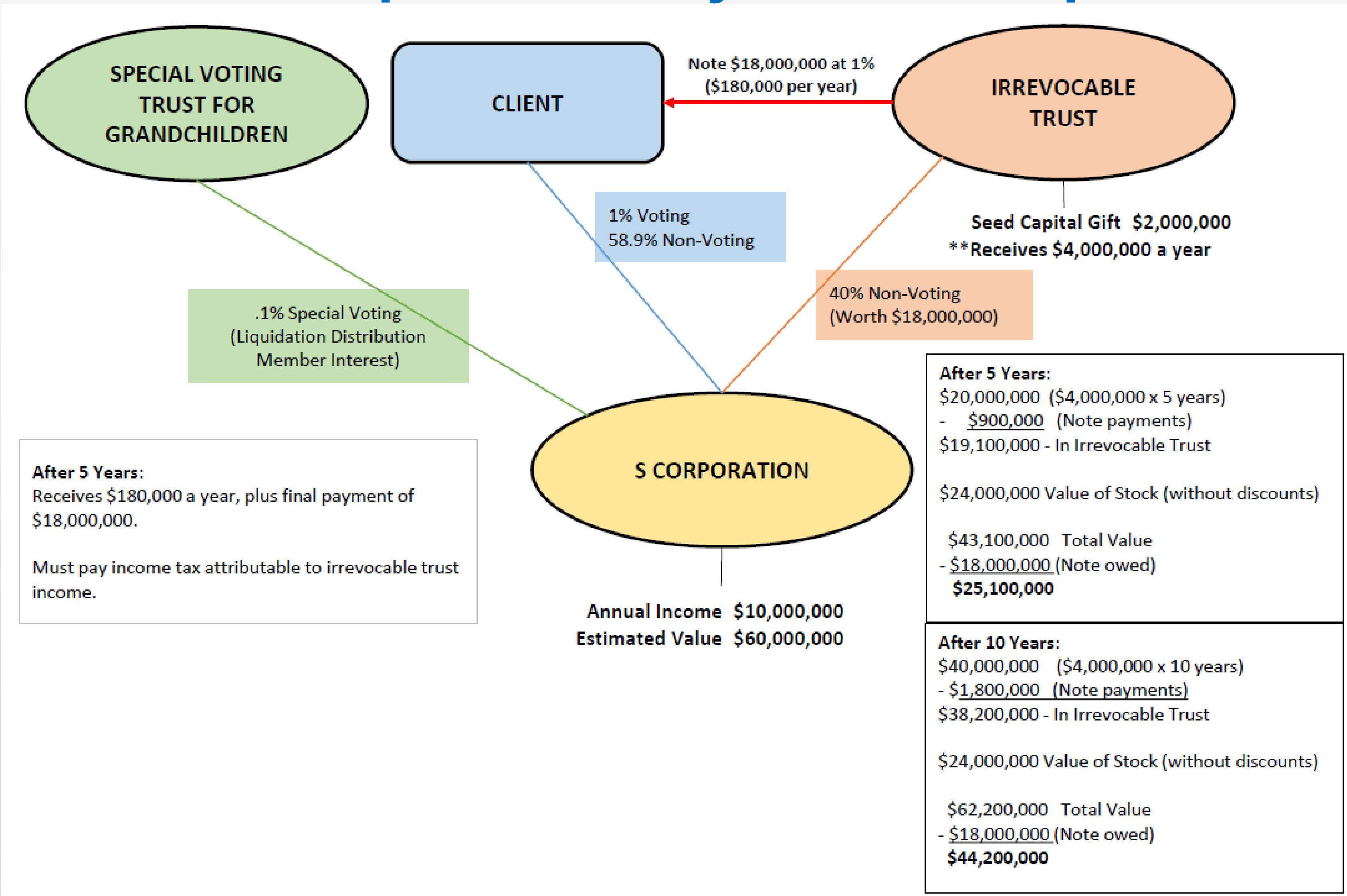
If the Seller is in the 36% tax bracket, then she has received $6,000,000 a year, plus $180,000 per year in the first five years, and has paid $3,600,000 a year in federal income taxes. She has therefore netted $12,900,000 in five years.

At the end of year 5, she may wish to turn off grantor trust status immediately after being paid in full on the promissory note.

As a result of this, the trust will continue to receive 40% of the income of the Company, and will have $25,100,000, plus the growth thereon, to invest.

The above assumes that the Company does not grow in value and that income does not go up.

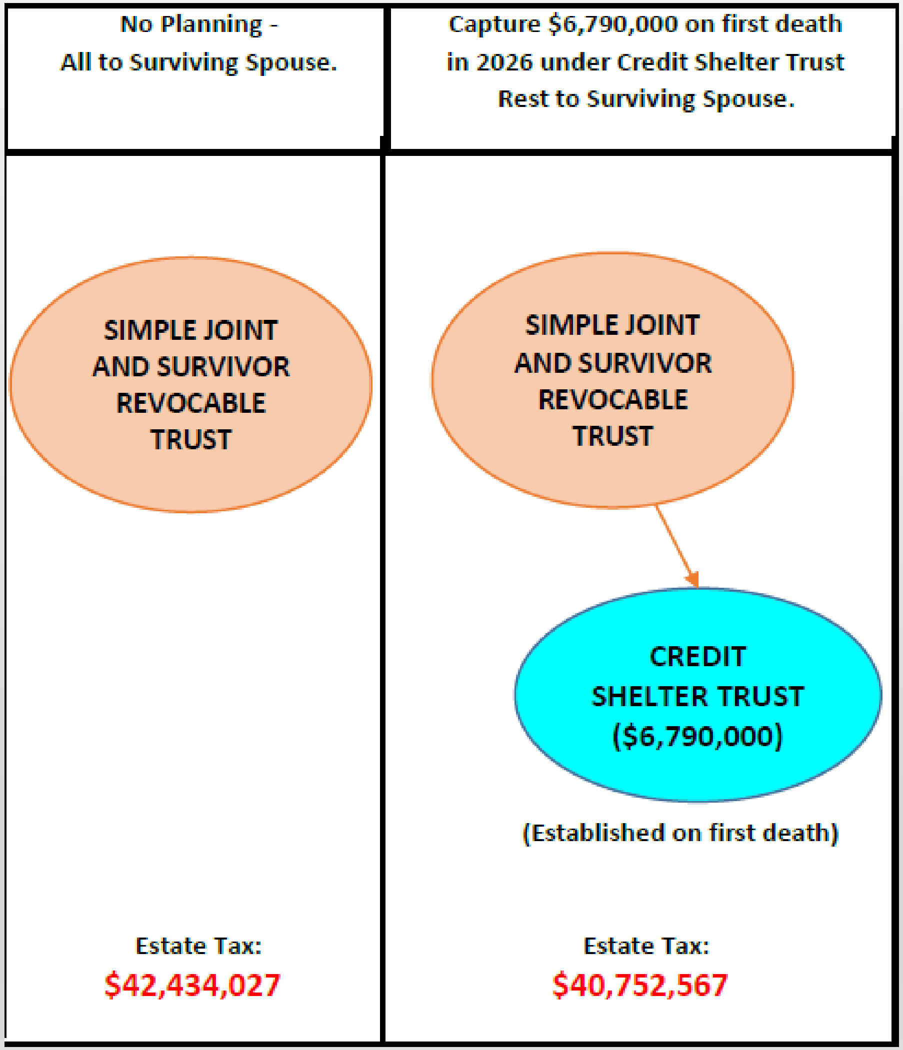
After Installment Sale
Biden 2-Step for Closely Held S Corporation



Fourth Installment Sale Demonstration – Comparing This Strategy To Outright Gifting And Other Variations

Married Couple with $4,000,000 Home (3.25% Growth Rate) and $48,000,000 in Investments (5.5% Growth Rate) – Save $300,000/Yr – Husband Dies in 6 Years, Wife Dies in 15 Years

Estate Tax with No Planning $42,434,027

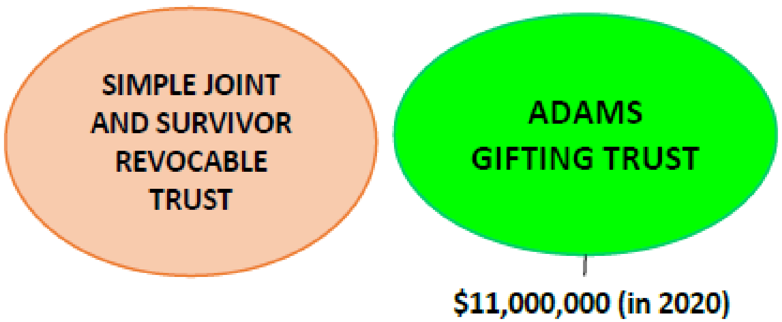


Married Couple with $4,000,000 Home (3.25% Growth Rate) and $48,000,000 in Investments (5.5% Growth Rate) – Save $300,000/Yr – Husband Dies in 6 Years, Wife Dies in 15 Years

Estate Tax with No Planning $42,434,027

Fund $11,000,000 Trust
in 2020.

(EXAMPLE 1)



Estate Tax:
$34,605,171

(EXAMPLE 1)

Under the first scenario, George makes an $11,000,000 gift to the Irrevocable Trust in 2020, and the assets under the Trust produce income and/or growth based on a total of 5% a year, net of expenses.

This would bring the estate tax in year 15 down from $40,752,567, which was the original amount that we reviewed to apply, if no planning is done other than George leaving a $6,790,000 By-Pass Trust on his death to $34,605,171.

A $6,147,396 estate tax savings.

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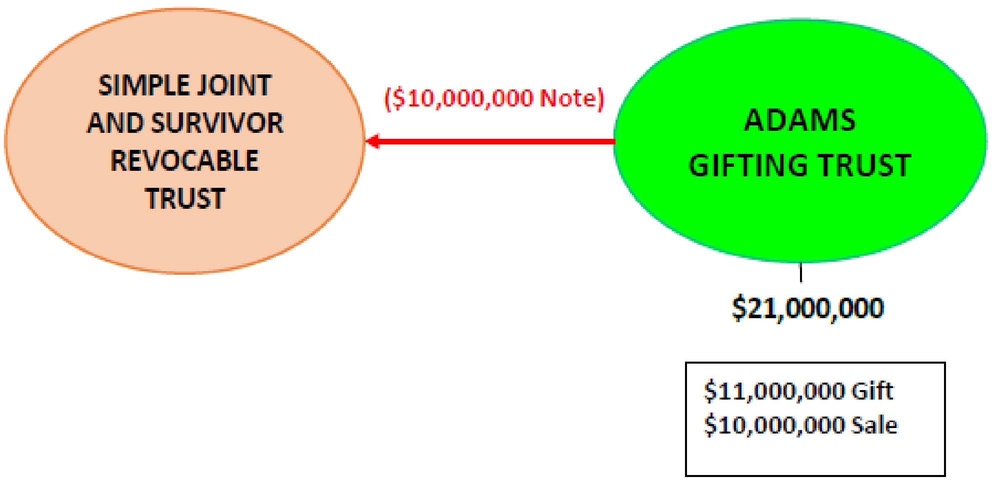
Married Couple with $4,000,000 Home (3.25% Growth Rate) and $48,000,000 in Investments (5.5% Growth Rate) – Save $300,000/Yr – Husband Dies in 6 Years, Wife Dies in 15 Years

Estate Tax with No Planning $42,434,027

Fund Irrevocable Trust with $11,000,000 of assets,
and sell an additional $10,000,000 of assets, trust has
$21,000,000 and owes George $10,000,000 at 1% interest.
(EXAMPLE 2)



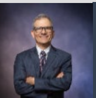
Estate Tax:
$30,571,612

(EXAMPLE 2)

The next alternative is that instead of only transferring $11,000,000 worth of assets to the Trust, George sells another $10,000,000 worth, so that the Trust has $21,000,000 in assets producing a 5% rate of return, and owes George $10,000,000 at 1% interest.

After 15 years, this Trust would be worth $36,367,267, that would pass estate tax-free to the children on the second death.

The estate tax savings on this would be an additional $4,033,559, based upon the assumptions we are using.



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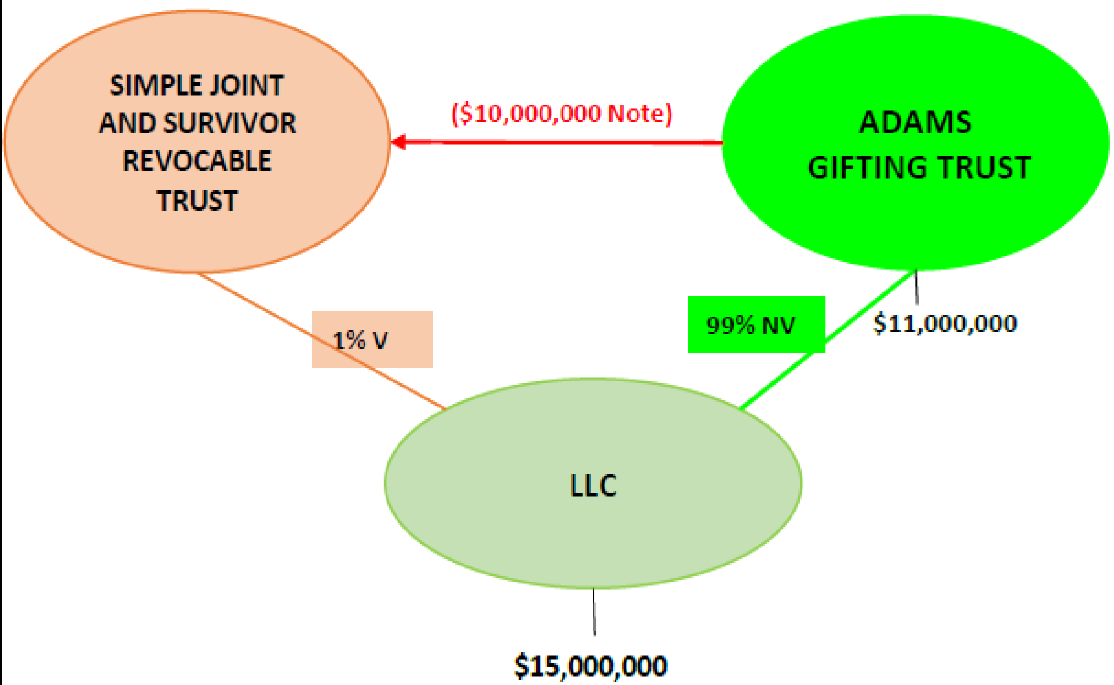
Married Couple with $4,000,000 Home (3.25% Growth Rate) and $48,000,000 in Investments (5.5% Growth Rate) – Save $300,000/Yr – Husband Dies in 6 Years, Wife Dies in 15 Years

Estate Tax with No Planning $42,434,027

George puts $11,000,000 in the Irrevocable Trust
and $15,000,000 into LLC.
Sells 99% ownership in LLC for $10,000,000 note.
(EXAMPLE 3)



Estate Tax:
$26,106,659

(EXAMPLE 3)

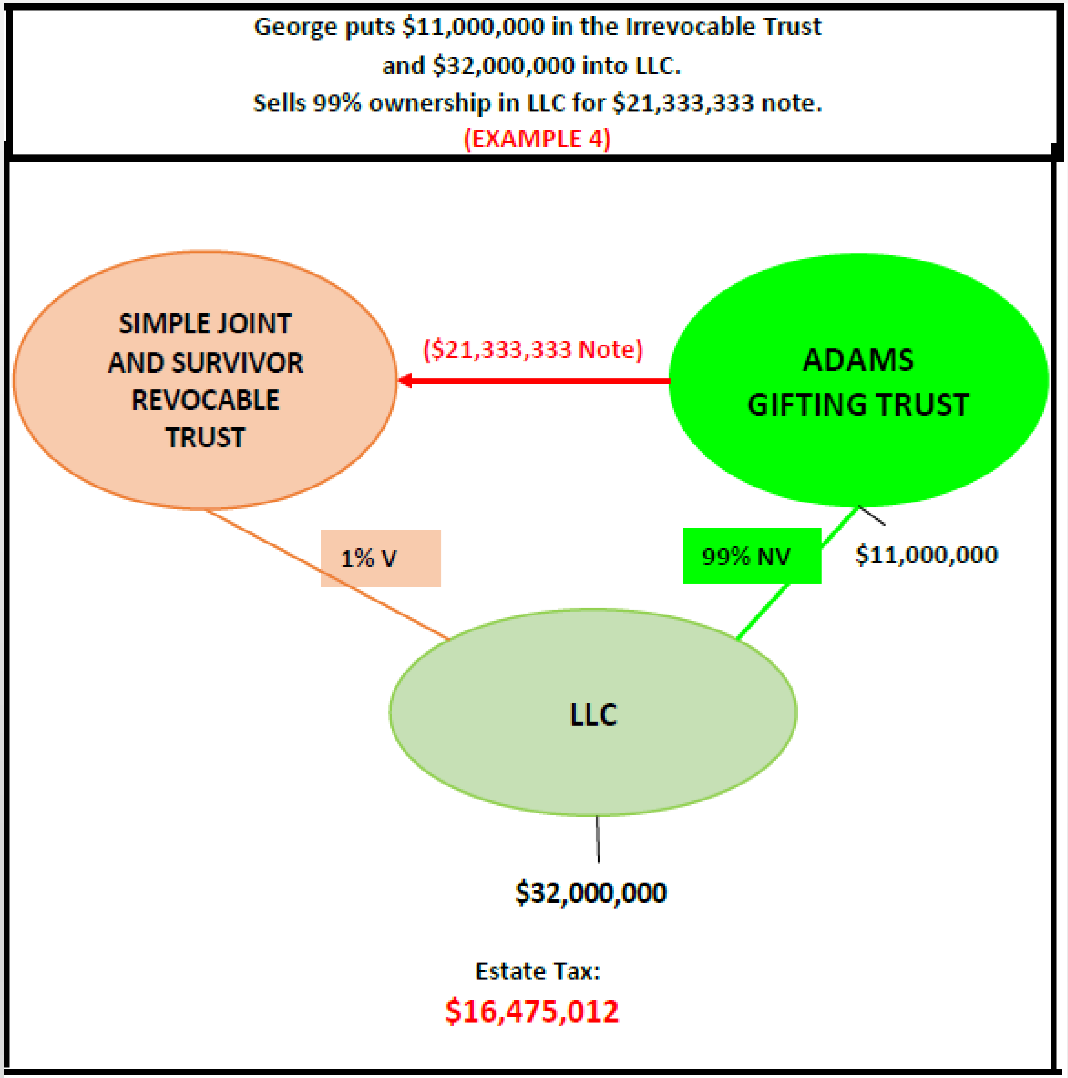
For the third example, I have assumed that George would put $15,000,000 into an LLC and sell the 99% non-voting member interest in the LLC for a $10,000,000 note.

This puts an additional $5,000,000 (approximately) into the Irrevocable Trust, and brings the value of the Irrevocable Trust on the second death to $47,482,132.

The additional estate tax savings is $4,464,953.

Married Couple with $4,000,000 Home (3.25% Growth Rate) and $48,000,000 in Investments (5.5% Growth Rate) – Save $300,000/Yr – Husband Dies in 6 Years, Wife Dies in 15 Years

Estate Tax with No Planning $42,434,027



(EXAMPLE 4)

For the fourth example, I have assumed that George would put $32,000,000 into an LLC and sell the 99% non-voting member interest in the LLC for a $21,333,333 note.

This puts an additional $10,666,667(approximately) into the Irrevocable Trust (as compared to example 3), and brings the value of the Irrevocable Trust on the second death to $71,418,122.

The additional estate tax savings is $9,631,647.

Estate Planning Technique(s) Used	Total Estate Tax Liability	Additional Estate Tax Savings Over Previous Step	Cumulative Estate Tax Savings
No planning.	$42,434,027	N/A	N/A
1. Creation of Credit Shelter Trust on Death of First Dying Spouse	$40,752,567	$1,681,460	$1,681,460
2. **INSTEAD** Making a Gift to an Irrevocable Trust of $11,000,000	$34,605,171	$6,147,396	$7,828,856
3. Item 2 **PLUS** Selling $10,000,000 to Revocable Trust in Exchange for Low-Interest Note	$30,571,612	$4,033,559	$11,862,415
4. Item 2 **PLUS** Placing $15,000,000 into an LLC and selling a 99% Non-voting Interest for a $10,000,000 Note.	$26,106,659	$4,464,953	$16,327,368
5. Item 2 **PLUS** placing $32,000,000 into an LLC and selling a 99% Non-voting Interest for a $21,333,333 Note.	$16,475,012	$9,631,647	$25,959,059

The Biden 2 Step & The Biden 3rd Step

LEIMBERG Information Services, Inc.

A Leimberg Information Services Webinar Presentation

EXCERPTS FROM

The Biden 3rd Step - What To Do With Your Promissory Note Before Year-End

Wednesday, December 22, 2021

From 2:00 to 3:30 PM EST

(90 minutes)

Alan Gassman
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The Biden 3rd-Step: Strategies

1. **Abort the Mission and Leave the Dance Floor.**

   Some taxpayers may elect to step back, meaning that they wish to reverse the process completely, and only entered the dance floor because they feared the exemption would revert to a lower amount, such as $5,000,000.

   Now that the exemption amount is not expected to be drastically reduced, at least for the next couple of years, that same individual wants a less complicated plan than the Biden 2-step.

1. Abort the Mission and Leave the Dance Floor. (Cont.)

For Example:

- An older, unmarried individual with $5 million worth of assets that wants to minimize his or her estate and related estate taxes can spend and gift significant amounts each year and invest primarily in fixed-income securities, such as bonds, to stay well below half of what the future forecasted exemption amount.

- This same individual would normally invest significant amounts in stocks and mutual funds, or income producing real estate, but now he or she may feel comfortable holding fixed-income investments. The family financial planner may adjust the investment mix of the next generation, so that they have more in equities and less in fixed income, knowing that they will probably inherit the senior family member's fixed income portfolio when she passes this to them upon death.

- If the next generation will be estate taxable, they would have been better off having the senior family member ("Senior") invest in equities and engage in the Biden 2-Step, because what they inherit from Senior can be passed under Inheritance Trusts, which can benefit Senior's family member's children, grandchildren and great-grandchildren without ever being subject to federal estate tax at their levels.

- If Senior's descendants also have no estate tax issues, then the strategy of having him invest primarily or entirely in fixed income assets, while family members invest in growth assets, may be sound, although it would seem better to allow Senior to invest in growth assets that would have a new fair market value income tax basis upon her death to the extent possible.

The Biden 3rd-Step: Strategies

2. Transfer the Note to an Asset Protection Trust.

A note could be transferred to an Asset Protection Trust that is considered to be an "incomplete gift" for federal estate and gift tax purposes by reason of the Grantor having the right to consent before any distribution can be made to any person other than the Grantor, and a testamentary Power of Appointment, which may be exercisable solely in favor of descendants of the Grantor, or perhaps up to 25% to future spouses, charities or other individuals or entities, and 75% solely for the descendants of the Grantor.

While the note would still be includable in the Grantor's estate for estate tax purposes, it would be protected from creditors of the Grantor, assuming that the law of the asset protection jurisdiction is controlling, and also from undue influence and "next spouse" claims as well.

The trust could be drafted so that the Grantor could make the trust a "completed gift trust" by just renouncing her right to consent to distributions and her retained power of appointment, and at that time she will be considered to have made a complete gift of the assets under the trust to the Trustee, without further legal work and transfers being needed.

The Biden 3rd-Step: Strategies

3. **<u>Convert the Note Into an Annuity.</u>**

Noteholders who live in states that provide creditor protection for annuities may wish to convert the note, in whole or in part, to an annuity right.

Planners who draft documents such as Grantor Retained Annuity Trusts (GRATs) and Qualified Personal Residence Trusts (QPRTs) that will or may make annuity payments should review applicable state law to determine how such payments will be treated for creditor exemption purposes.

Example:

In the 2019 case of *in re Resin* (aka the Pink Hippo case) Cayman Island annuity contracts purchased by a trustee of an asset protection trust that was found to be penetrable by the south Florida Bankruptcy Court were held to be protected when the trustee purchased them and made them payable to the debtor without the debtor's assistance. The Court found that the Florida fraudulent transfer statute did not apply where the debtor did not make the transfer and did not request that the trustee of a very old and cold trust to make the transfer.

3. Convert the Note Into an Annuity. (Cont.)

Alternatively, a note could be converted in whole or in part to a private annuity, subject to the possibility that the Probability of Exhaustion Test would need to be satisfied in order to avoid having a gift occur at the time of conversion.

The Probability of Exhaustion Test under Section 7520 Treasury Regulations and Revenue Ruling 77-374 generally provides that the payer trust must have a sufficient net worth, and/or guarantors who pay guarantee payments, to assure that all annuity payments can be made until the payee reaches age 110, under the assumption that the assets available to satisfy the payments will grow only at the Section 7520 rate, which is 1.6% in December of 2021.

Example:

A Grantor age 70 making a seed capital gift of $1,000,000 to a Spousal Limited Access Trust ("SLAT") could contribute $10,000,000 of assets to the SLAT and take back an annuity paying him $813,246.15 per year for life, or a 14 Year promissory note in the amount of $10,000,000 at 1.90% (based on the December long-term AFR) not self-cancelling, or 6.050% if self-cancelling.

Private annuity payments can be very flexible. They can be deferred and/or increase annually by a certain percentage.

In the *Kite* case, Mrs. Kite contributed $10,605,278 worth of assets to her trusts in exchange for annuity payments that would begin ten years from the date of the transfer in the amount of $1,900,679.34 annually until the death of Mrs. Kite.

3. Convert the Note Into an Annuity. (Cont.)

In a recent private annuity structure, a 73-year-old wanted to have $2,400,000 a year to spend for the first nine years, and then the remaining payments for his lifetime would be based on the value of the assets contributed to the trust to avoid a gift.

- If the 73-year-old transfers $35,000,000 to the trust he could receive $2,400,000 for the first nine years, and $3,816,570 annually for his remaining lifetime.
- His wife will be well supported by the SLAT, which has over $92,000,000 in value.
- The taxpayer will continue to pay the income tax on income earned by the SLAT.
- There are sufficient assets in the trust to satisfy the Probability of Exhaustion Test, and the taxpayer's estate can be kept under the remaining amount of his estate tax exemption to avoid federal estate tax.

The Biden 3rd-Step: Strategies

4. <u>Use a "Zero'd Out" CLAT.</u>

The Zero Estate Tax Charitable Estate Plan — ConCLATulations

- The estate tax is a voluntary tax for those who don't mind having a significant portion of their wealth going to public or family controlled charities.

- Many clients who are owed large promissory notes may not be aware of the ability to transfer a note or other assets to a Charitable Lead Annuity Trust ("CLAT") during life or upon death to qualify for a 100% estate and/or gift tax charitable deduction while expecting half or more of the assets involved to pass to be held for the benefit of family members after a term of years during which payments are made to one or more charities as determined each year by the family.

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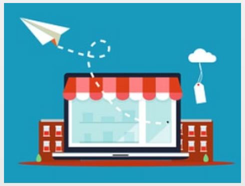
4. Use a "Zero'd Out" CLAT (Cont.)

The strategy of placing a promissory note into an LLC and then transferring the non-voting LLC interests to a CLAT has been approved by the IRS in multiple Private Letter rulings.



Example:

In Private Letter Ruling 201907004, the IRS ruled that the self-dealing rules would not prevent an individual who established and funded a CLAT from contributing a promissory note that was owed to him as the result of a sale of assets to a trust for the taxpayer's descendants.

The note had a 30-year duration and paid interest only until it ballooned at the end of the 30th year.

The 1% voting member interest in the LLC that received the note was held by the Grantor's daughter as trustee of an irrevocable trust for the Grantor's descendants.

The Grantor's 99% non-voting member interest in the LLC was the sole asset conveyed to the CLAT, and the only assets owned by the LLC were the note and a small amount of cash that was expected to be sufficient to pay for administrative costs relating to the LLC.

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4. Use a "Zero'd Out" CLAT (Cont.)

- The words "zeroed out," means that the present value of the annual payment rights to the charitable organization equals 100% of the value of the CLAT, based upon the discount factors set forth in IRC Section 7520 and Treasury Regulations thereunder.

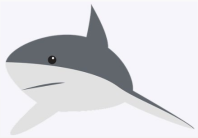
- Using commercially available software, such as NUMBER CRUNCHER or TIGER TABLES, a tax professional can determine an annual percentage of the value of the CLAT that can be paid to charity as a fixed annual payment.

- Better results can be achieved by using the 120% payment structure that was approved by PLR 201216045, and are permitted under the Grantor Retained Annuity Trust ("GRAT") Regulations, so that each annual payment is increased by 20%.

Example:

> If the LLC interests transferred to a zeroed out CLAT is valued at $10 million upon inception for a term of 15, followed by having the remainder of the CLAT assets held in trust for descendants when the 7520 rate is 1.6% (as it is upon writing this letter) then the first annual payment will be $165,131.22, the fifth payment will be $342,416.10, the tenth payment will be $852,040.82 and the fifteenth payment will be $2,120,150.22.

4. Use a "Zero'd Out" CLAT (Cont.)



Sharky and the Machine

- A more aggressive form of CLAT that requires customized calculations would pay only $1,000 a year for the first fourteen years, and then a final full payment in the fifteenth year. This is known as a "SHARK-FIN CLAT".

- The financial results to be realized under a 20% per year increase in CLAT payment are not significantly better than the use of a SHARK-FIN CLAT, especially when taking into consideration that the IRS may challenge SHARK-FIN CLATS, but is unlikely to challenge their previously published opinion in a PLR related to the 20% annual increase in payments.

- If the note is owed to the CLAT by a defective Grantor Trust, and the CLAT is also disregarded for income tax purposes as a "Grantor CLAT," then there should be no income recognized when the note payments are made to the LLC to enable the LLC to make payments to the charitable organization.

- CLATs can be terminated early by having all payments that would have gone to the charity made at the time of termination, without any discount.

- If the Grantor of CLAT would like to see the charitable purposes that are being funded completed earlier, or is concerned that a death during the term of the CLAT could cause a significant income tax event, then termination of the CLAT during the Grantor's lifetime can be a good planning idea.

The Biden 3rd-Step: Strategies

5. **<u>Safely Gifting the Note – Wandry, Petter, Q-TIP, What's Better?</u>**

When there has been an installment sale to a defective Grantor Trust in exchange for non-voting membership or limited partnership interests, the remaining estate tax exemption of the taxpayer may be in doubt.

Example:

> If the taxpayer made a seed capital gift of $5 million to a defective Grantor Trust and then sold 99% non-voting LLC member interests in a company holding $75 million of assets in exchange for a $50 million 20-year low interest promissory note, a $5 million gift may have been reported, but upon audit the IRS might conclude that the 99% non-voting membership interest in the LLC was worth $55 million instead of $50 million, and that the taxpayer has made a $5 million gift, and will therefore only have $2,060,000 of estate tax exemption in 2022 as opposed to $7,060,000.
>
> If the taxpayer files a gift tax return in 2022 that fully discloses the $5 million gift and the installment sale, then the IRS will have until three years after the filing of the return (2025) to audit the return.

Should the taxpayer therefore wait until after the statute runs in 2025 before making a gift of any portion of the note? Can the taxpayer safely use a formula clause transfer, or a lifetime QTIP Trust arrangement to gift as much of the note as possible without triggering gift tax?

The answer is "most likely" with a formula transfer note, and "almost definitely" with a lifetime QTIP.

5. Safely Gifting the Note – Wandry, Petter, Q-TIP, What's Better? (Cont.)

A formula transfer of a note can be based upon a conveyance document which basically provides that "I hereby give a percentage ownership in the attached note, based upon a fraction, the numerator of which is $10,000 less than my remaining federal gift tax exemption, and the denominator of which is the face value of the note.

> For example, if the taxpayer's remaining exemption turns out to be $4 million in the above example, and there is a $50 million note, then if there is no discount for a partial interest in the note or to take into account that a low interest note is worth less than its face value, then $4 million divided by $50 million is 8% of the note that will be considered as transferred.

If there is a 20% discount because of the duration and low interest rate of the note, then 80% of $50 million is $40 million, and if there is a 15% discount to take into account that a fractional interest in a note is not worth as much pro-rata as a separate and distinct part of a note, the combined discount would be 32% and a portion of the note that is worth $4 million would be based upon $5,882,352 divided by the total face amount of the note.

Will fractional transfers like this be approved by the Tax Court?

While we have the benefit of the *Wandry* decision, and now the *Nelson* decision, both of these were Tax Court Memorandum decisions, which have no precedential value, but certainly show us what certain Tax Court judges are thinking.

The safer approach for a fractional transfer is still to use the *McCord/Petter* charitable overflow arrangement, which was found by the Ninth Circuit Court of Appeal to not be against public policy. Under this arrangement, the note transfer can be something like the following:

> I hereby transfer one-tenth (1/10) of one percent (1%) of the Forty Million Dollar ($40,000,000) note to the ABC COMMUNITY FOUNDATION, and a percentage of the note, as determined by the appraisal firm of DEF APPRAISERS to be worth an amount equal to the lesser of (1) $11,700,000 or (2) my otherwise remaining estate tax exemption to the ABC TRUST, and retain the remaining portion of the note. If the value of the portion of the note passing to the ABC TRUST as finally determined for federal gift tax purposes exceeds my gift tax exemption amount, then the excess shall go to the ABC COMMUNITY FOUNDATION.

It may be important to use a public charity so that the self-dealing rules are not a concern.

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The QTIP Statutory Solution:

A Qualified Terminal Interest Property Trust ("QTIP") is a trust that must pay all income and may pay principal to the spouse of the Grantor, and can qualify for the federal gift tax marital deduction.

The primary advantage of the lifetime QTIP with respect to a difficult to value transfer is that the Grantor can make a statutorily recognized formula marital deduction election to treat a designated portion of the QTIP Trust as qualifying for the estate tax marital deduction, while leaving a portion of the QTIP Trust to be considered to be a gift that would use part of the Grantor's exemption.

The downsides of this technique are:

(1) The portion of the QTIP that will be outside of the Grantor's estate must pay income to the surviving spouse, and will therefore be a bit "leaky," unless it owns assets that do not yield income, and

(2) The arrangement may seem a bit complicated.

(3) A portion of the note passing to qualify for the marital deduction may provide more benefits for a spouse than the Grantor intended.

Advantages are (1) creditor protection, and (2) next spouse/undue influence protection, and (3) in some states the donor can become the beneficiary of the trust after the death of the spouse/beneficiary and not be considered to be a contributor to the trust for creditor protection purposes if the donor can only access assets as needed for health, education, maintenance and support, or with the consent of an unrelated trustee who the donor may appoint, subject to appropriate language and constraints.

5. Safely Gifting the Note – Wandry, Petter, Q-TIP, What's Better? (Cont.)

The QTIP Statutory Solution: EXAMPLE

1. The taxpayer still has a $50,000,000 promissory note, and expects to have a $7,060,000 estate and gift tax exemption, after having made a $5,000,000 seed capital gift and sale to the defective Grantor Trust.

2. The taxpayer transfers a 20% ownership interest in the $50,000,000 note, which would have a face value of $10,000,000, to a lifetime QTIP Trust for the taxpayer's spouse, which will pay the spouse all income for the spouse's lifetime, and can allow the Trustee to make principal payments to the spouse in the discretion of a Trustee who can be replaced by the Grantor at any time. The remainder interest of the QTIP Trust will not pass to the Grantor's descendants.

3. In 2022, the Grantor files a gift tax return and makes an election to have the QTIP Trust divide into QTIP Trust A and QTIP Trust B.

4. QTIP Trust A will be equal to a fraction of the total QTIP Trust that is equal in value to the Grantor's estate and gift tax exemption amount, which is thought to be $7,060,000.

5. The remainder of the QTIP Trust will be known as QTIP Trust B, and will qualify for the federal estate tax marital deduction.

6. QTIP Trust A can be generation-skipping tax exempt, based upon the use of the Grantor's GST exemption. QTIP Trust B may pass as a GST exempt asset, if the spouse/beneficiary elects to have the spouse's GST exemption allocated to the Trust in what is called a reverse QTIP election.

7. As the result of the above, the two QTIP Trusts are administered based upon the appraiser's conclusion that the note can be discounted 20%, because it has a long term and a low interest rate, and therefore valued at $8,000,000 for gift tax purposes, so that 17.65% of the note is allocated to QTIP Trust A, and 2.35% is allocated QTIP Trust B.

8. The IRS may audit the 2021 gift tax return and come to the conclusion that the note is worth its face amount, and that there should be no discount for any purposes. If the family chooses to not disagree with the IRS because of other issues that might arise in the audit, then the note may shift to be considered as owned 14.12% by QTIP Trust A and 5.88% owned by QTIP Trust B.

9. At some point, the Trustee of QTIP Trust B may transfer its 2.35% of the note to the Grantor's spouse, who may elect to transfer the note to joint names between the Grantor's spouse and the Grantor.

10. That portion of the note might be paid in full after four or more years from the conveyance of the note to the QTIP Trust B, and the remaining portion of the note may also be paid in full, so that QTIP Trust A may invest in growth stocks that pay very little in dividends.

The Biden 3rd-Step: Strategies

6. **<u>Using the Exemption for a QPRT Instead of Note Reduction.</u>**

Other alternative uses of the taxpayer's gift tax exemption may be considered.

If the taxpayer's homestead is expected to grow in value or to at least retain its value, and the Grantor is expected to live for longer than the period chosen as the retained use interest, then use of part of the taxpayer's gifting allowance for one or more QPRTs that can own all or a part of the taxpayer's primary residence and one other personal residence, can be the most effective use of gift tax exemption.

Example on the following slide.

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6. Using the Exemption for a QPRT Instead of Note Reduction. (Cont.)

Example:

An individual age 60 may own 50% of a homestead worth $2,000,000 with her spouse owning the other 50%. Assuming a 15% discount that may apply for a 50% interest, and a 10 year retained use interest, the gift of half of the homestead to a QPRT would use $619,250 of the taxpayer's gift tax exemption, but the entire 50% ownership of the home would be excluded from federal estate taxes, if the taxpayer dies after the 10-year term.

- If the home grows at 3.5% a year in value and the taxpayer dies in year 20, then 50% of the home would at that time be worth $3,652,753, and would be excluded from the taxpayer's estate, in addition to rent that the taxpayer would pay to use the home in years 11 through 15.

- If rent is based upon 8% of the value of the home, and able to be reinvested at a 7% rate of return then the total estate tax savings would be $2,289,966.

- Alternatively, half of the home could be sold for an installment note to a trust and the taxpayer could pay one-half of the fair rental value of the home in order to have use thereof.

- If the home is placed in an LLC, and the taxpayer retains a 1% voting member interest and sells a 99% non-voting member interest in the LLC in exchange for the note, this may yield a better economic result, but is harder to understand, and could cause loss of state law homestead TAX advantages.

- A homeowner in Florida could use either technique and still maintain the Florida homestead tax exemption, and have the advantage of the 2% per year cap on the increase in assessed value by using a 98-year or longer lease with fair market value rent.

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The Biden 3rd-Step: Strategies

7. <u>Give the Note Some SCIN.</u>

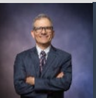
Another advantage of keeping the note outstanding is the ability to maintain or convert it to a self-cancelling installment note, in whole or in part, so that the death of the Grantor or the Grantor's spouse can cause the note not to be included in the Grantor's estate, without having to use the Grantor's estate tax exemption to reduce or eliminate it.

Example:

If the Grantor is age 60 and the note issued in November of 2021, then the long-term applicable federal rate is 1.86%, and the premium rate to facilitate the self-cancelling installment note that will become due and payable on the grantor's 21 year life expectancy based on the 2000CM life expectancy tables will be 2.278%, for a total of 4.138% interest.

If the Grantor dies during the 21 year period, then the note is cancelled, and the family is much better off if the Grantor would otherwise be estate taxable.

If the Grantor has a health condition or family history that would cause it to be more probable than not that death would occur before the balloon, then this could be a good strategy.



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Whether to Make the Note Self-Canceling

The IRS takes the position that a self-canceling note is worth significantly less than the face value, if the lender whose life is referenced has less than a normal life expectancy.

The statutes permit a private annuity sale using standard life expectancy amounts, if the lender whose life is used has better than a 50% chance of living at least one year at the time that the arrangement is put into place.

Private annuity sales normally do not work as well as sales for promissory notes because:

a. Special "probability of exhaustion" rules require that any trust purchasing assets in exchange for a private annuity must have a significant amount of assets, which will usually significantly exceed the amount of the note.

b. An individual sale for a private annuity can trigger significant ordinary income (when a defective grantor trust is not being used).

7. Give the Note Some SCIN. (Cont.)

- Until the IRS took the position in the Tax Court case of Estate of Davidson that the standard life expectancy tables cannot be used in structuring a self-cancelling installment note, most practitioners and commentators were of the opinion that a self-cancelling installment note can be structured without gift risk, if the noteholder had a better than 50% chance of surviving at least one year after the note is issued, or, in fact, survived at least 18 months, because of Treasury Regulation §25.7520-3(b)(3), which applies these standards when assets are sold for a private annuity contract.

- A promissory note is very much like a private annuity, because it provides for fixed annual payments that are clearly measurable at the time that the note is issued.

- The Davidson case was settled, so there may be no authority that a note cannot be structured with payments that would analogized to a private annuity, while using the better than 50% chance of survival standard.

- The terminal illness requirement under the Section 7520 Treasury Regulations prevents use of normal life expectancy assumptions, if there is a "terminal illness," which is an incurable illness or other deteriorating physical condition that causes the transferor to have a 50% or higher probability of dying within one year.

  "Individuals suffering from the general infirmities of old age, but not from a specific, incurable life-threatening illness" are not considered to be terminally ill under the regulations. If an elderly person has one or more illnesses, none of which standing alone are considered to be life-threatening, then that person would not be considered terminally ill. Several serious diseases and conditions, such as heart disease, diabetes, many forms of cancer, and Alzheimer's Disease, do not automatically reduce life expectancy to a 50% probability of death within one year, until these afflictions have progressed to advanced stages."

7. Give the Note Some SCIN. (Cont.)

- Families who are concerned about the possibility of paying gift tax at the time that a SCIN is entered into can consider the SCGRAT strategy discussed in LISI Newsletter #2230 (June 3, 2014), whereby the Grantor places valuable assets in an LLC that is owned by the Grantor. The LLC gives the Grantor a self-cancelling installment note, which causes the value of the LLC to be very small, if the promissory note is worth its face amount.

- The Grantor then gifts the 99% non-voting member interest in the LLC and some cash or marketable securities to a "zeroed out" Grantor Retained Annuity Trust ("GRAT") in exchange for the right to receive two annual payments.

- Each payment will be worth approximately 51.20% of the day one value of the LLC as of the moment that it was transferred to the GRAT. The payment can be satisfied by paying cash that the LLC can distribute to the GRAT or in the form of assets equal in value to such amounts that the LLC may distribute to the GRAT each year. When the Grantor has established one or more Defective Grantor Trusts, such trusts may transfer cash to the GRAT in exchange for LLC interests, so that the GRAT has money to use to pay to the Grantor as scheduled.

If it turns out that the self-cancelling installment note has a very small value, then the Grantor will be owed larger payments from the GRAT, and no gift tax will be due.

The possibility that a Grantor, who is diagnosed with a condition that dramatically reduces life expectancy, can convert a promissory note to be self-cancelling can be a significant advantage to maintaining the note.

Conclusion

- Taxpayers who have taken the first step in selling assets to disregarded trusts in exchange for promissory notes have many opportunities and possibilities to consider in determining whether to terminate or have the note repaid.

- For estate tax planning purposes, the best result may be facilitated by forgiving the note, but not always.

- Practical concerns such as marital rights, creditor protection, and whether a commitment should be made.

Sample Client Letter

Click **HERE** for a PDF version.

Dear _______________:

Thank you very much for providing us with the opportunity to help you with the funding and installment sale that was completed this year.

As I am sure you are aware, the political situation resulted in no estate and gift tax law changes, so the $11,700,000 estate tax exemption will go up to $12,060,000 on January 1st, and the $15,000 per year annual gifting exclusion will be $16,000 on January 1st.

There will doubtlessly be continuous efforts to reduce the estate tax exemption and eliminate planning opportunities that now exist, but hopefully this will not be anytime soon.

Realistically, and assuming that no major deals are struck that would have some Republican participation, it seems unlikely that the estate and gift tax rules will change in the near future unless more seats in the Senate pass to the Democrats in the 2022 election.

One question for your planning is whether you should forgive the promissory notes owed by the ___________ Trust and the _____________ Trust to you by using estate tax exemption.

The primary advantage of note forgiveness will be that interest payments will not have to be made to you going forward, so that your estate will be smaller.

The primary disadvantage is the loss of flexibility in case you would ever want to withdraw significant funds or other assets from the trusts, or to change how the amounts owed to you by the trusts would pass during your lifetime or in the event of death.

There was a recently published article and a professional webinar on this topic that you may want to read and/or watch.

I can send you a link to the webinar if this is of interest, and a copy of Part I and II of the article is attached.

Please let me know if you have any questions or would like to discuss this, and thank you as always for the opportunity to be of service.

Best personal regards.

$10,000,000 PROMISSORY NOTE/SCIN/PRIVATE ANNUITY ALTERNATIVES
JANUARY 2021
FRED AND WILMA FLINSTONE

ALTERNATIVES: (USING JANUARY 2021 APPLICABLE FEDERAL RATE AND 7520 RATE)

All Notes and the Private Annuity are based on an initial sale amount of $10,000,000

FRED (AGE 66 FOR TAX PURPOSES) ← **TRUST** (PURCHASER)

- 3 Year Interest Only Installment Note @ .14% - **Payment = $14,000 per year***
- 9 Year Interest Only Installment Note @ .52% - **Payment = $52,000 per year***
- 10+ Year Interest Only Installment Note @ 1.35% - **Payment = $135,000 per year***
- 17 Year Interest Only SCIN @ 4.210% - **Payment = $421,000 per year***
- Private Annuity Level Annual Payments - **Payment = $626,532 per year**

* Notes would have no penalty for prepayment - minimum payments are shown above. Self-Canceling Installment Notes (SCINs) must balloon before life expectancy as measured at time of Note being made. Fred's life expectancy is 17.05 years under IRS tables. The SCIN calculation above is based on a 17-year note term.

Note: January 2021 rates are:
Short-Term – .14%
Mid-Term -- .52%
Long-Term – 1.35%
(Usable through March 31, 2021)
Section 7520 Rate – .6%

ALTERNATIVES: (USING JANUARY 2021 APPLICABLE FEDERAL RATE AND 7520 RATE)

All Notes and the Private Annuity are based on an initial sale amount of $10,000,000

WILMA (AGE 66 FOR TAX PURPOSES) ← **TRUST** (PURCHASER)

- 3 Year Interest Only Installment Note @ .14% - **Payment = $14,000 per year***
- 9 Year Interest Only Installment Note @ .52% - **Payment = $52,000 per year***
- 10+ Year Interest Only Installment Note @ 1.35% - **Payment = $135,000 per year***
- 17 Year Interest Only SCIN @ 4.210% - **Payment = $421,000 per year***
- Private Annuity Level Annual Payments - **Payment = $626,532 per year**

* Notes would have no penalty for prepayment - minimum payments are shown above. Self-Canceling Installment Notes (SCINs) must balloon before life expectancy as measured at time of Note being made. Wilma's life expectancy is 17.05 years under IRS tables. The SCIN calculation above is based on a 17-year note term.

Note: January 2021 rates are:
Short-Term – .14%
Mid-Term – .52%
Long-Term – 1.35%
(Usable through March 31, 2021)
Section 7520 Rate – .6%

ALTERNATIVES: (USING JANUARY 2021 APPLICABLE FEDERAL RATE AND 7520 RATE)

All Notes and the Private Annuity are based on an initial sale amount of $10,000,000

FRED & WILMA, jointly ← **TRUST** (PURCHASER)

- 3 Year Interest Only Installment Note @ .14% - **Payment = $14,000 per year***
- 9 Year Interest Only Installment Note @ .52% - **Payment = $52,000 per year***
- 10+ Year Interest Only Installment Note @ 1.35% - **Payment = $135,000 per year***
- 21 Year Interest Only SCIN @ 3.205% - **Payment = $320,500 per year***
- Private Annuity Level Annual Payments - **Payment = $502,690 per year**

* Notes would have no penalty for prepayment - minimum payments are shown above. Self-Canceling Installment Notes (SCINs) must balloon before life expectancy as measured at time of Note being made. Fred & Wilma's joint life expectancy is 21.96 years under IRS tables. The SCIN calculation above is based on a 21-year note term.

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Short-Term -- .14%
Mid-Term – .52%
Long-Term -- 1.35%
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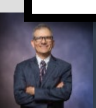
Section 7520 Rate – .6%



Using the SCIN strategy:

- A Self-Canceling Installment Note (SCIN) is often used for Promissory Notes between family members.
- Ideally, the Payee dies before the Note is fully repaid (the family is happier this way!), and any remaining balance is forgiven upon death. Thus, the value is not included in the Payee's estate.
- However, the IRS takes the position that a SCIN can only be entered into if the Payee is in reasonable health, and is generally expected to live to the normal expectancy.
- The forgiveness feature is not considered to be a gift when:
  - The Note is subject to a premium interest rate (in excess of the AFR) - OR
    - if the required interest rate would be usurious, then a premium is added to
    - the Note's principal at its inception.

Using the SCIN strategy (continued):

- It is crucial that note payments be made on a timely basis.

- Failure to make timely payments gives the IRS
- ammunition to deem the indebtedness as illusory.

- It is also normally recommended that the note be secured by collateral or other guarantors.

Using the SCIN strategy (continued):

- Estate planning calculators allow the planner to enter various scenarios to see if the Payee's age would trigger a disallowed usurious interest rate, which means that the SCIN should have a premium increase on the principal of the note instead.
- Risk assessment is required:
- Planners must obviously consider whether it's worthwhile to pay a higher interest rate or principal premium that will increase the Payee's estate if he/she lives to collect it in full.

Whether to Make the Note Self-Canceling

The IRS takes the position that a self-canceling note is worth significantly less than the face value, because of the probability of dying during the note term.

The statutes permit a private annuity sale using standard life expectancy amounts, if the lender whose life is used has better than a 50% chance of living at least one year at the time that the arrangement is put into place.

Private annuity sales normally do not work as well as sales for promissory notes because:

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Give the Note Some SCIN. (Cont.)

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> “Individuals suffering from the general infirmities of old age, but not from a specific, incurable life-threatening illness” are not considered to be terminally ill under the regulations. If an elderly person has one or more illnesses, none of which standing alone are considered to be life-threatening, then that person would not be considered terminally ill. Several serious diseases and conditions, such as heart disease, diabetes, many forms of cancer, and Alzheimer’s Disease, do not automatically reduce life expectancy to a 50% probability of death within one year, until these afflictions have progressed to advanced stages.”

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The possibility that a Grantor, who is diagnosed with a condition that dramatically reduces life expectancy, can convert a promissory note to be self-cancelling can be a significant advantage to maintaining the note.

Private Annuities

Slides from Professor Jerry Hesch

Private Annuity - is a financial arrangement between two parties, typically family members, where one party (the "annuitant") transfers ownership of an asset to another party (the "obligor") in exchange for a regular stream of income for the rest of the annuitant's life. Unlike traditional annuities offered by insurance companies, private annuities are not regulated by financial institutions and can offer unique benefits in certain situations.

Introduction to Private Annuities in Estate Planning

1.Definition of Private Annuities:

1. A private annuity is a financial arrangement used in estate planning.
2. Involves transferring an asset from the grantor to a beneficiary in exchange for a promise to make periodic annuity payments to the grantor for the remainder of their life.

2.Key Parties Involved:

1. Grantor: The individual transferring the asset.
2. Beneficiary: The individual receiving the asset and making annuity payments.

3.Benefits of Private Annuities:

1. Facilitates asset transfer while providing a steady income stream for the grantor.
2. Can reduce the grantor's taxable estate.
3. Potential estate and gift tax benefits, depending on certain conditions.

Mechanism of Private Annuities

Process Overview:

- Grantor transfers an asset (property, investments, etc.) to the beneficiary.
- In return, the beneficiary promises to pay the grantor a fixed annuity for life.
- The annuity payments continue until the grantor's death.

Determining Annuity Amount:

- Annuity amount is based on actuarial calculations.
- Factors include the asset's value, grantor's age, prevailing interest rates, and life expectancy.

Tax Implications:

- Initial transfer is not subject to income tax.
- Annuity payments may have income tax consequences for both parties.
- Potential estate and gift tax implications to consider.

Slides from Professor Jerry Hesch

Advantages of Private Annuities in Estate Planning

Steady Income Stream:

- Grantor receives regular annuity payments, ensuring financial stability.

Estate Tax Reduction:

- Asset transferred is removed from grantor's taxable estate.
- Potential reduction in estate tax liability upon death.

Gift Tax Considerations:

- Potential to reduce gift tax liability for the grantor, depending on actuarial factors.

Slides from Professor Jerry Hesch

Implementation Steps and Expert Guidance

1. **Professional Consultation:**
   - Work with financial advisors, estate planners, and tax experts.
   - Ensure compliance with legal and tax requirements.

2. **Asset Valuation:**
   - Determine the value of the asset to be transferred.

3. **Actuarial Calculation:**
   - Calculate annuity payments based on relevant factors.

4. **Drafting the Agreement:**
   - Create a legally binding agreement outlining terms and conditions.

5. **Regular Review:**
   - Periodic evaluation of annuity payments and estate plan.

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Using a private annuity for a healthy individual.

H is age 62

W is age 60

- They have three adult children who are all married and have several grandchildren.

- They have $30,000,000 of income-producing assets that generate about a 7% investment rate of return or $2,100,000 in annual income. They pay __% of that income in income tax.

- Given that their income-producing assets are only $30,000,000, they cannot make two $12,000,000 taxable gifts and reciprocal SLATs may not be practical.

Slides from Professor Jerry Hesch

Proposal.

Step 1: H creates an irrevocable grantor trust for the benefit of W (primary beneficiary) and their descendants (children and grandchildren). H funds the SLAT with a $12,000,000 taxable gift and applies his $12,920,000 gift tax exemption to this taxable gift so that no gift tax is due.

Step 2: H sells $8,000,000 of income-producing assets to this grantor trust for a private annuity of $657,456.79 payable annually for the rest of H's life.*

Step 3: H and W retain their remaining $10,000,000 of income-producing assets.

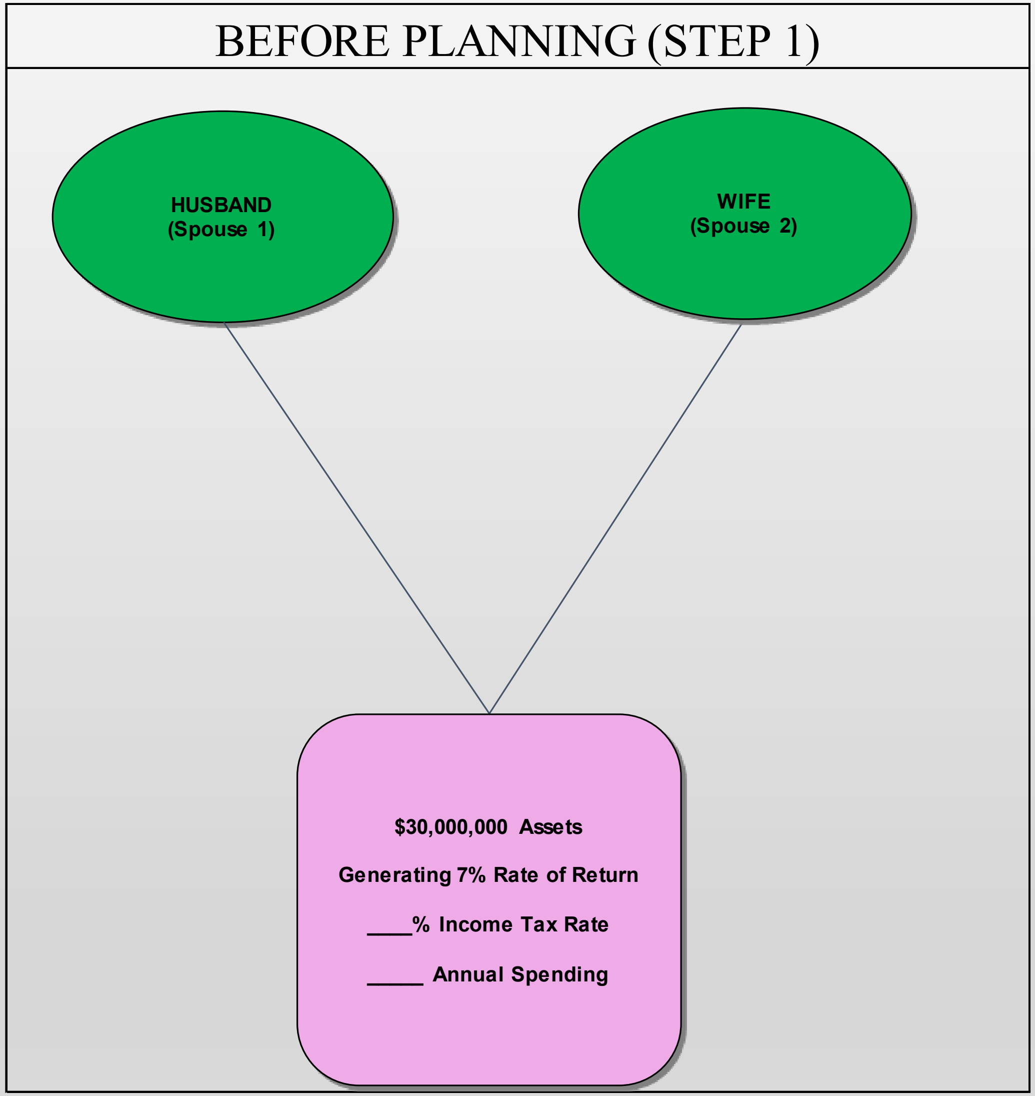
*** For an $8,000,000 annuity, the exhaustion test in Treas. Reg. 25.7520-3(b)(2) requires that the trust have $3,884,978 of separate reserves for an annuitant age 62 using a 5.0% §7520 rate.**

Slides from Professor Jerry Hesch

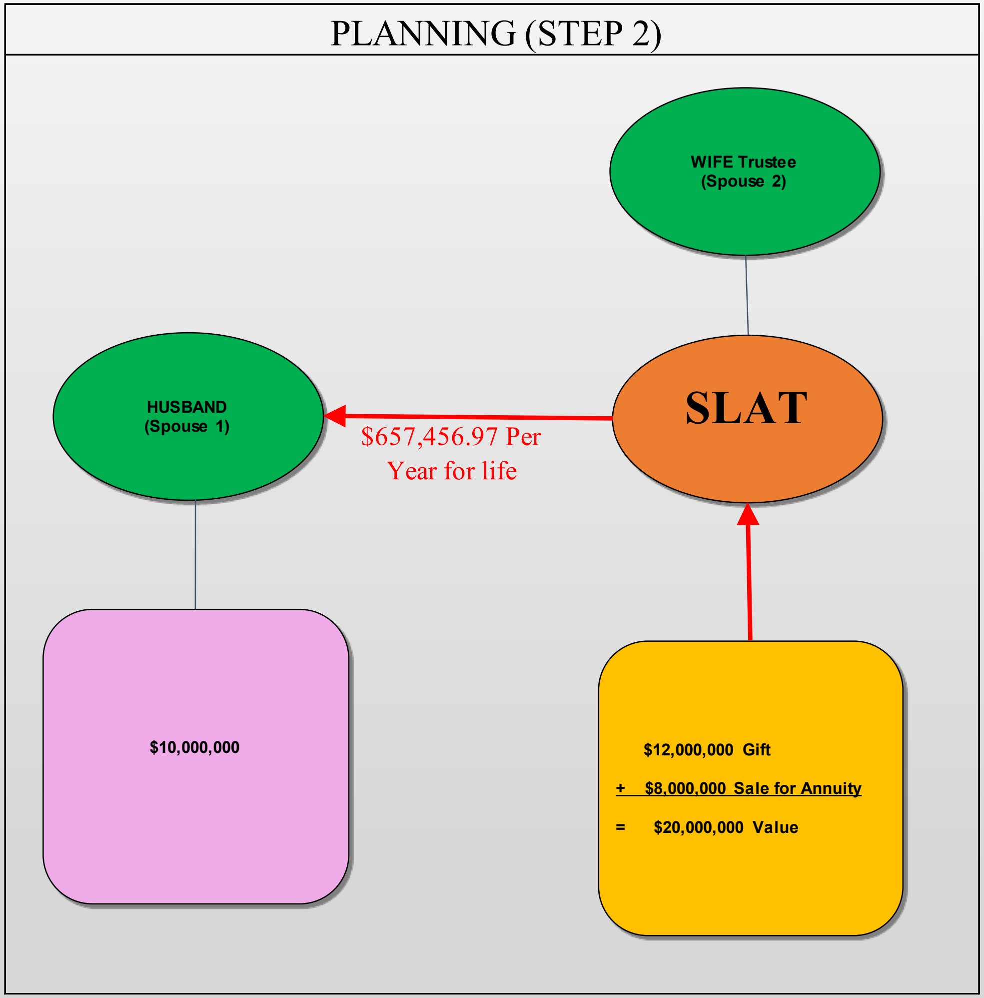
-Because the trust is a grantor trust, H will report the trust's taxable income on H's joint income tax return and have to pay the income taxes on the grantor trust's taxable income.

-While H and W are both living, they will have access to all the income from the $30,000,000 and pay the income taxes on all the income from the $30,000,000 ($20,000,000 owned by the SLAT and $10,000,000 retained by H and W). The income earned by the SLAT is $1,400,000 and the income earned by the retained assets is $700,000.
For illustrative purposes assume that the $30,000,000 of assets do not increase in value.

Slides from Professor Jerry Hesch



Slides from Professor Jerry Hesch



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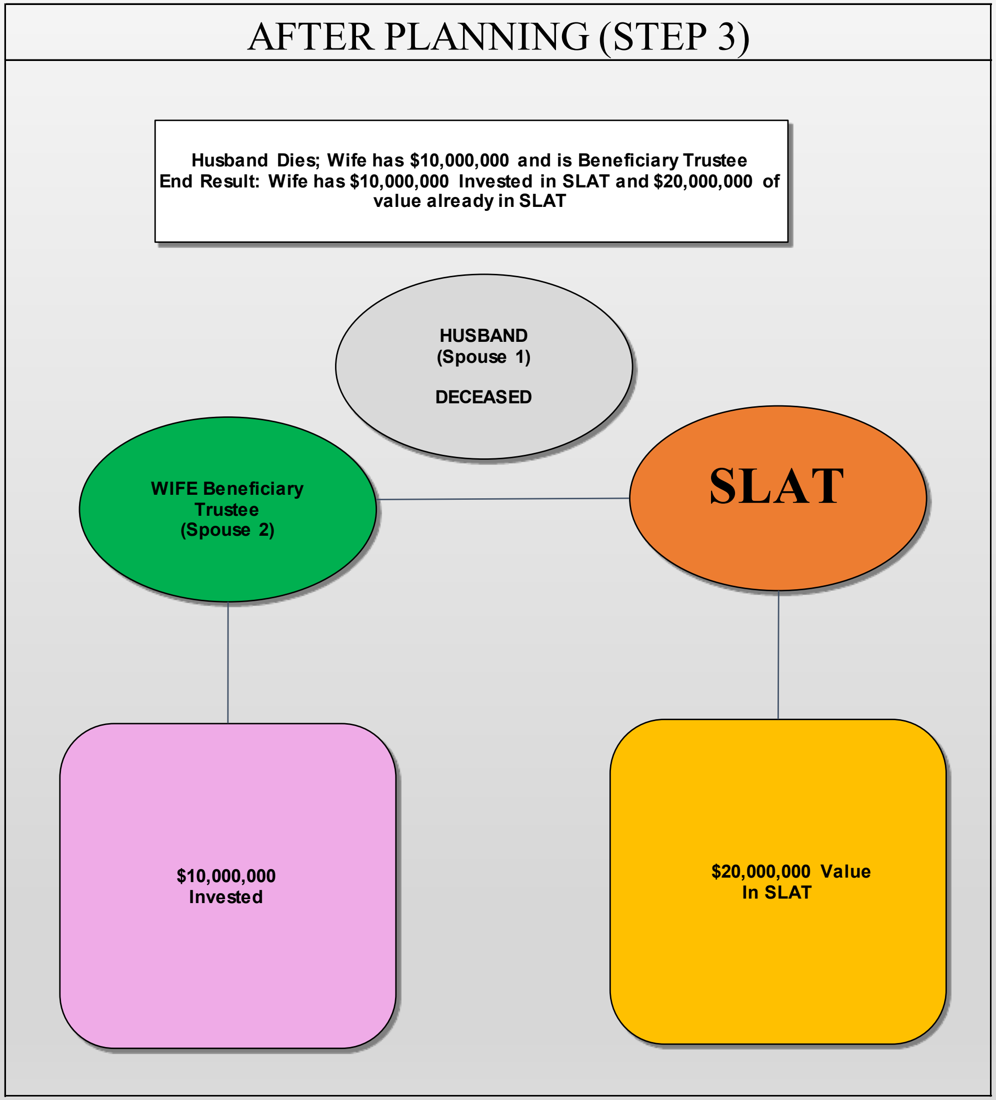

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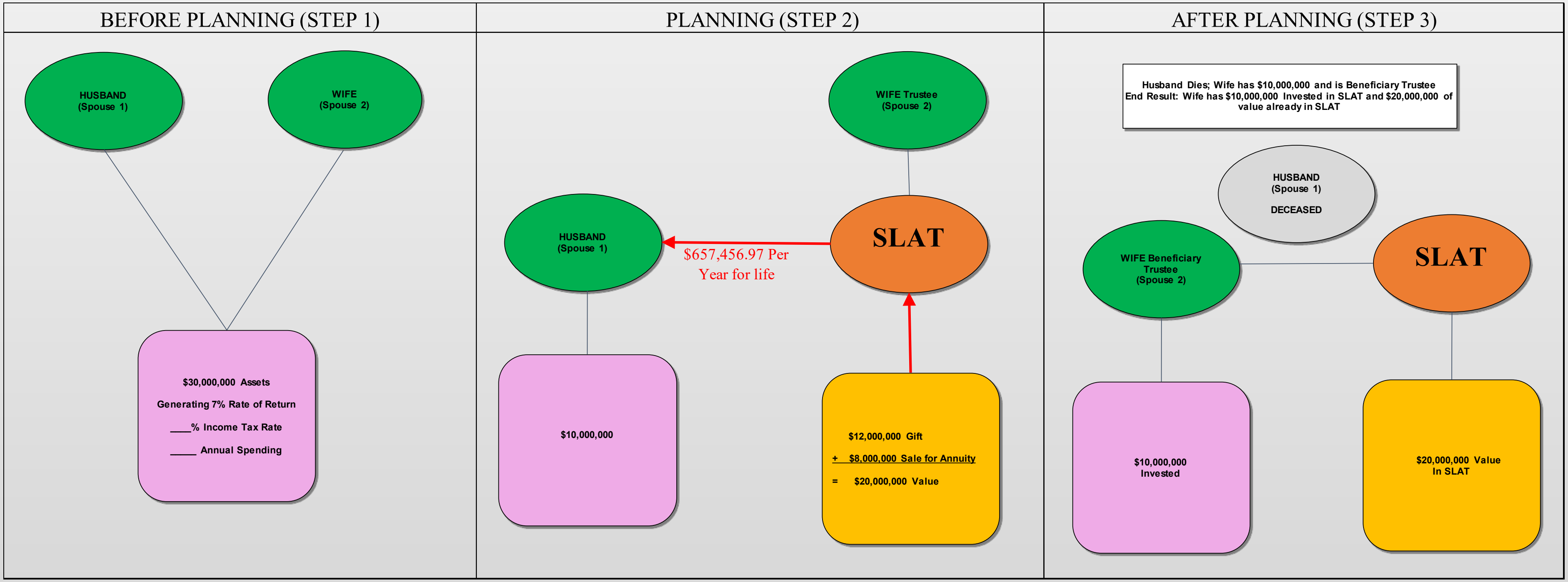

Slides from Professor Jerry Hesch

If H dies first: The SLAT's private annuity obligation terminates. The SLAT has $20,000,000 of income-producing assets, and all of a portion of its income can be distributed to W. H dies with $10,000,000 in his estate that is a marital deduction bequest for W. When W dies, her estate can leave a portion of H's $10,000,000 marital deduction to a by-pass trust and use W's estate tax exemption

If W dies first: H's private annuity continues and W dies with the $10,000,000 in her estate. H can access that portion of the $10,000,000 in his bypass trust and the rest in W's marital deduction bequest.

For estates with a value up to $30,000,000, there is no need to have dual SLATs.

trustate

Installment Sales to Irrevocable IDGTs

THANK YOU FOR PARTICIPATING!

Monday, May 19, 2025
1:00 PM to 2:00 PM ET
(60 minutes)

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