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Extremely Low Section 7520 Rate Provides Unique Tax Planning Opportunities

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AUTHORED ARTICLE | 11.22.2019

The following article was featured in the November 2019 edition of *Legacy*, the Vorys newsletter focused on wealth planning.

Significance of Section 7520 Rate

The Section 7520 rate is used in connection with the valuation of long-term or future property interests, such as annuities, life estates, remainder interests, and reversionary interests. Because the present value of each of these interests for tax reporting purposes is based on the Section 7520 rate, the low rate can result in certain gifted interests having a lower value for gift tax purposes.

Section 7520 Rate Is Currently Very Low

The Section 7520 interest rate is announced monthly by the IRS. The Section 7520 rate was lowered to 1.8% this October and remains low at 2.0% this November. A low Section 7520 rate affects a variety of estate planning techniques differently, but makes certain planning methods particularly advantageous. One of the most commonly used planning tools benefitted by the low Section 7520 rate is the Grantor Retained Annuity Trust (GRAT), described below.

Grantor Retained Annuity Trust (GRAT)

A GRAT is an irrevocable trust to which the grantor transfers assets and retains the right to receive a fixed annuity amount for a number of years. At the end of the GRAT term, any remaining assets after payment of the annuity will be transferred to the trust's designated beneficiary (or beneficiaries).

The creation of the GRAT is deemed to result in a gift to the beneficiaries of the value of the remainder interest they will receive. The value of the gift depends on the amount transferred to the trust, the length of the term, the amount of the annuity, and the Section 7520 rate. The lower the Section 7520 rate, the lower the amount the annuity payments must be in order to minimize the amount of the gift for any

given term.

The term of the GRAT and the amount of the annuity payments to the grantor are determined by the grantor at the time the GRAT is created. Generally, the term and the annuity payments are structured so that the amount of the taxable gift is very small. The grantor should contribute assets that are expected to grow at a rate in excess of the Section 7520 rate. If the assets contributed to the GRAT grow at a rate higher than the Section 7520 rate, the excess growth will be transferred to the remainder beneficiary of the trust free of gift tax. Although there are a number of other details and techniques that can be used in connection with the planning of a GRAT to optimize potential results, the foregoing are the key variables.

Example:

At a time when the Section 7520 rate is 2.0%, grantor transfers \$1M of securities to a 2-year GRAT with any remainder payable to a trust for the benefit of grantor's children. The GRAT is structured so that the annuity amount will be \$515,039.10 per year. Based on the Section 7520 rate of 2.0%, that annuity amount results in a taxable gift of \$0.08. The grantor outlives the 2-year term and receives a total of \$1,030,9078.20 in annuity payments. In other words, the grantor receives an amount equal to the amount transferred to the GRAT plus interest of 2.0%. If the trust assets grow at a rate greater than 2.0%, the excess amount will be distributed to the beneficiaries of the GRAT tax-free. For example, if the trust assets generate a return of 6% each year during the 2-year term, the remainder in the trust following the last annuity payment will be nearly \$63,000. This \$63,000 will pass to the beneficiaries free of gift tax at a "cost" of using only \$0.08 of grantor's lifetime gift tax exemption, and will not incur estate taxes at grantor's death.

One of the major benefits of a GRAT is that there is very little risk associated with the gift. Even if the assets unexpectedly grow at a rate of return lower than the Section 7520 rate, the grantor will still receive a return of the lesser of the required annuity payments or the total amount of the transferred assets, and will be charged with having made only a minimal gift. So long as the grantor survives the term, the beneficiary will receive any assets remaining in the trust at the end of the term, whatever that value may be. Thus, it can be viewed as a "no lose" proposition for the grantor, which can be attractive if the grantor would like to make gifts, but is concerned about retaining sufficient assets, or if the grantor has insufficient remaining gift tax exemption to make sizeable gifts. The only costs incurred are the use of a nominal amount of gift tax exemption (or payment of a gift tax if exemption has been exhausted) and the fees associated with establishing the GRAT and filing a gift tax return.

In addition to the GRAT, several other estate planning techniques become particularly valuable in a low Section 7520 rate environment. For example, a Charitable Lead Annuity Trust (CLAT) produces a result similar to a GRAT, but achieves philanthropic goals, in addition to providing a gift to one or more individual beneficiaries. Intrafamily loans and installment sales also offer different avenues for taking advantage of the low Section 7520 rate.

Contact your Vorys attorney to discuss whether a GRAT or other planning methods might be particularly suited to your estate plan as a result of the low Section 7520 rate.