



NORTHERN
TRUST

Lifetime Asset Transfers: An Overview

QPRTs, GRATs, and the Fundamentals of Sales to Grantor Trusts

Paul S. Lee, J.D., LL.M.
Global Fiduciary Strategist
The Northern Trust Company
New York, NY
PSL6@ntrs.com

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Lifetime Asset Transfers: An Overview



Mathematics Behind Lifetime Transfers

In the Estate

\$12.06 Mil.

Out of the Estate

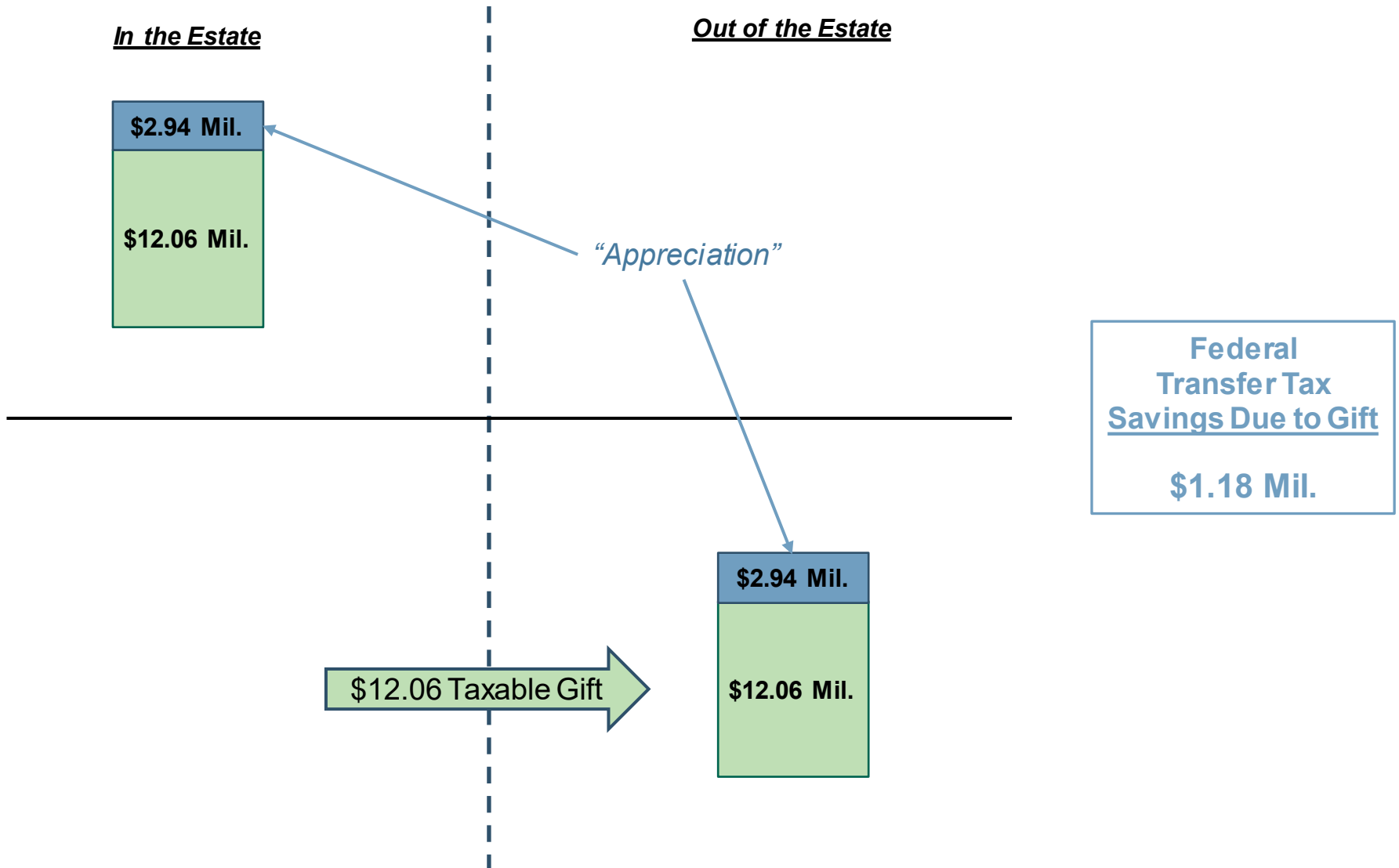
\$12.06 Taxable Gift

\$12.06 Mil.

Federal
Transfer Tax
Savings Due to Gift
\$0

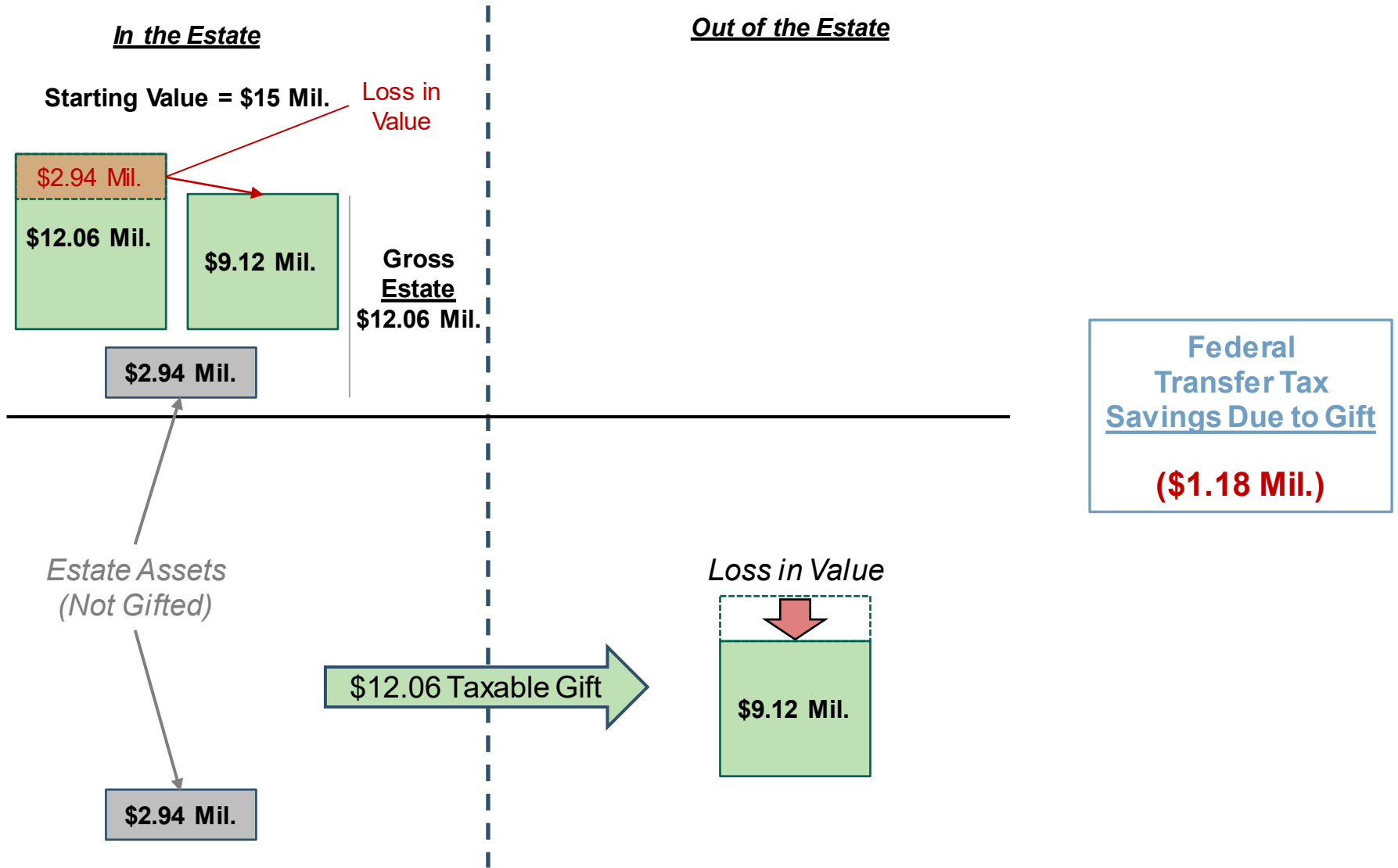


Mathematics Behind Lifetime Transfers: Appreciation



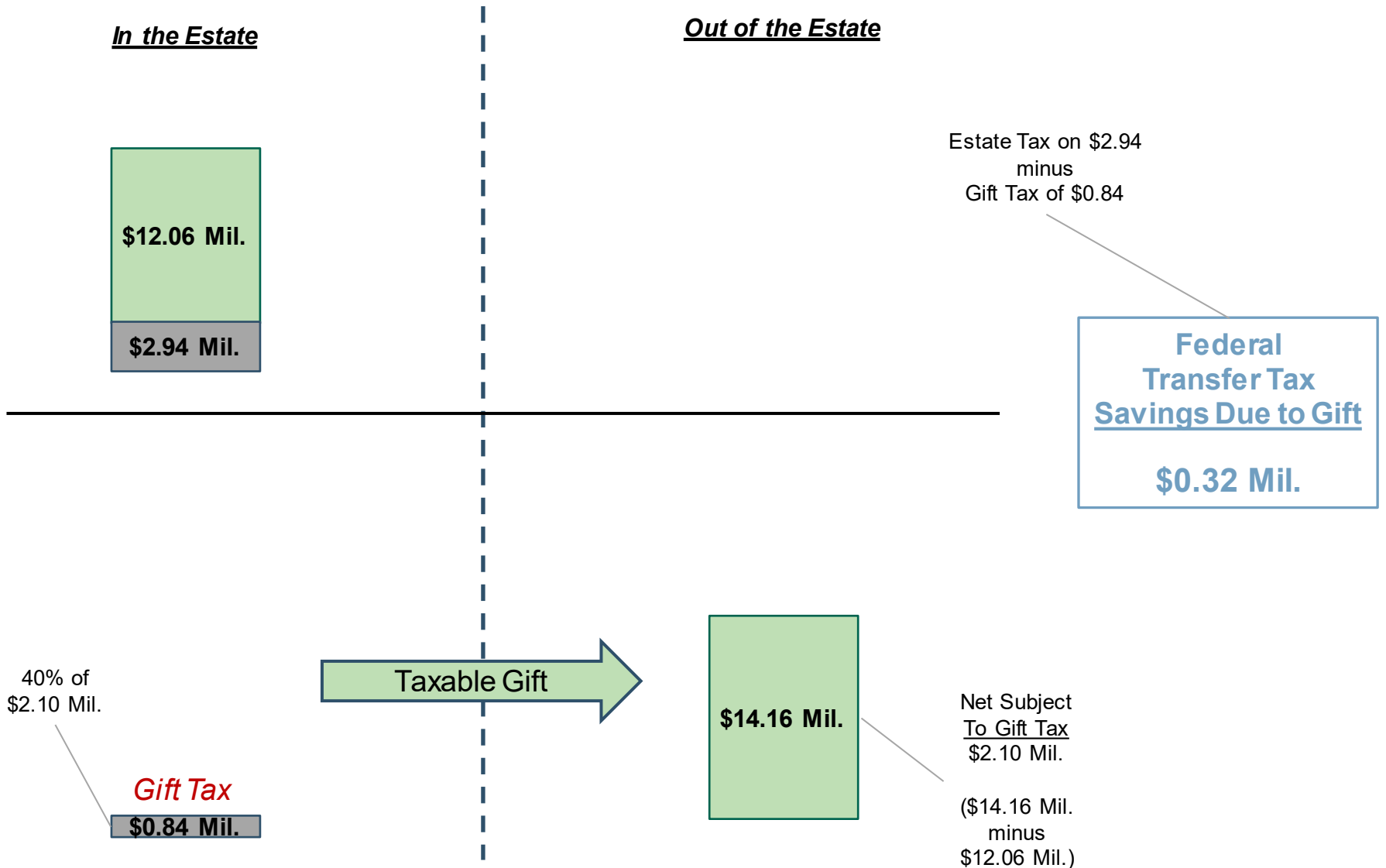


Mathematics Behind Lifetime Transfers: Loss In Value



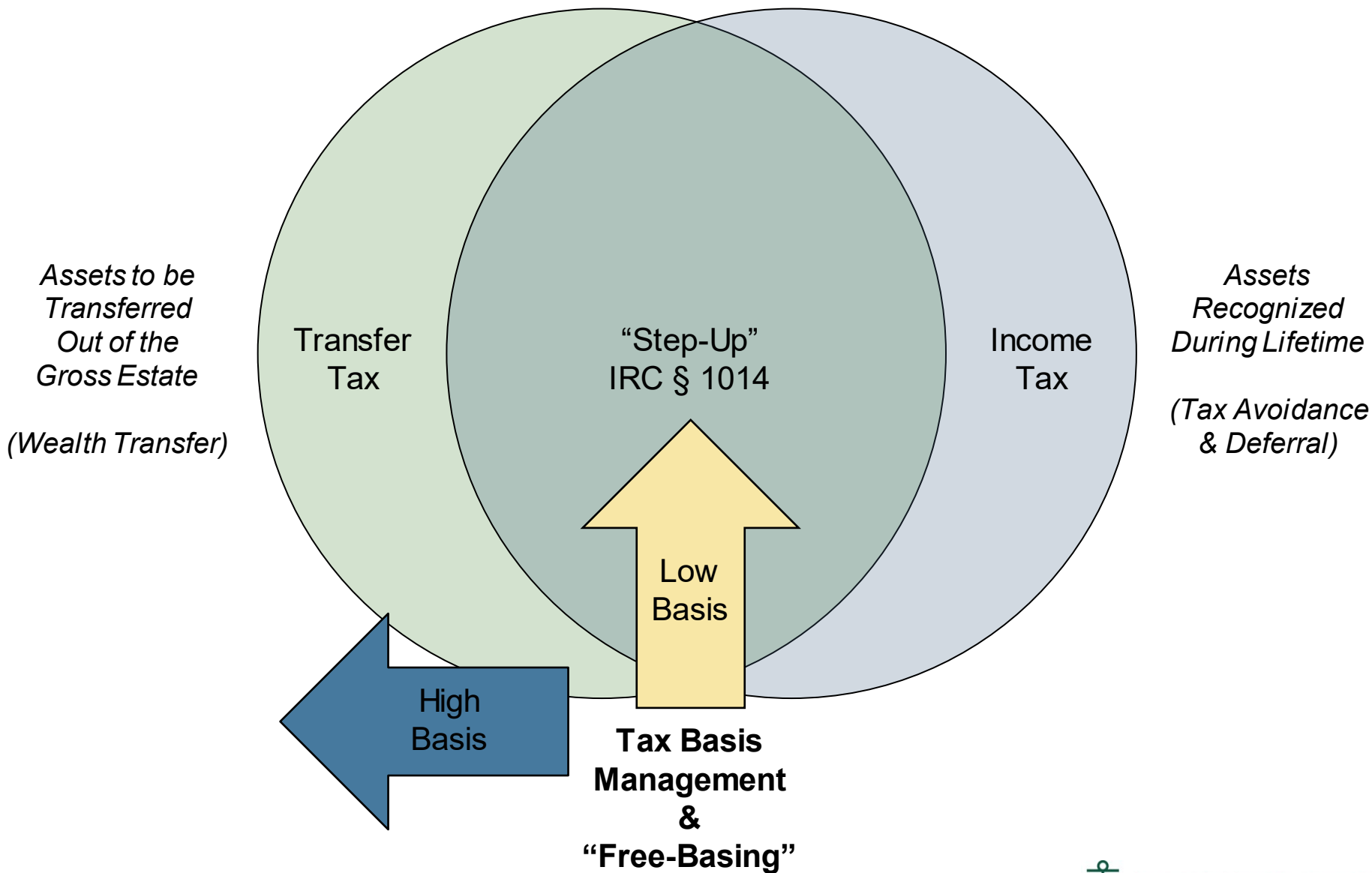


Mathematics Behind Lifetime Transfers: Tax Exclusivity



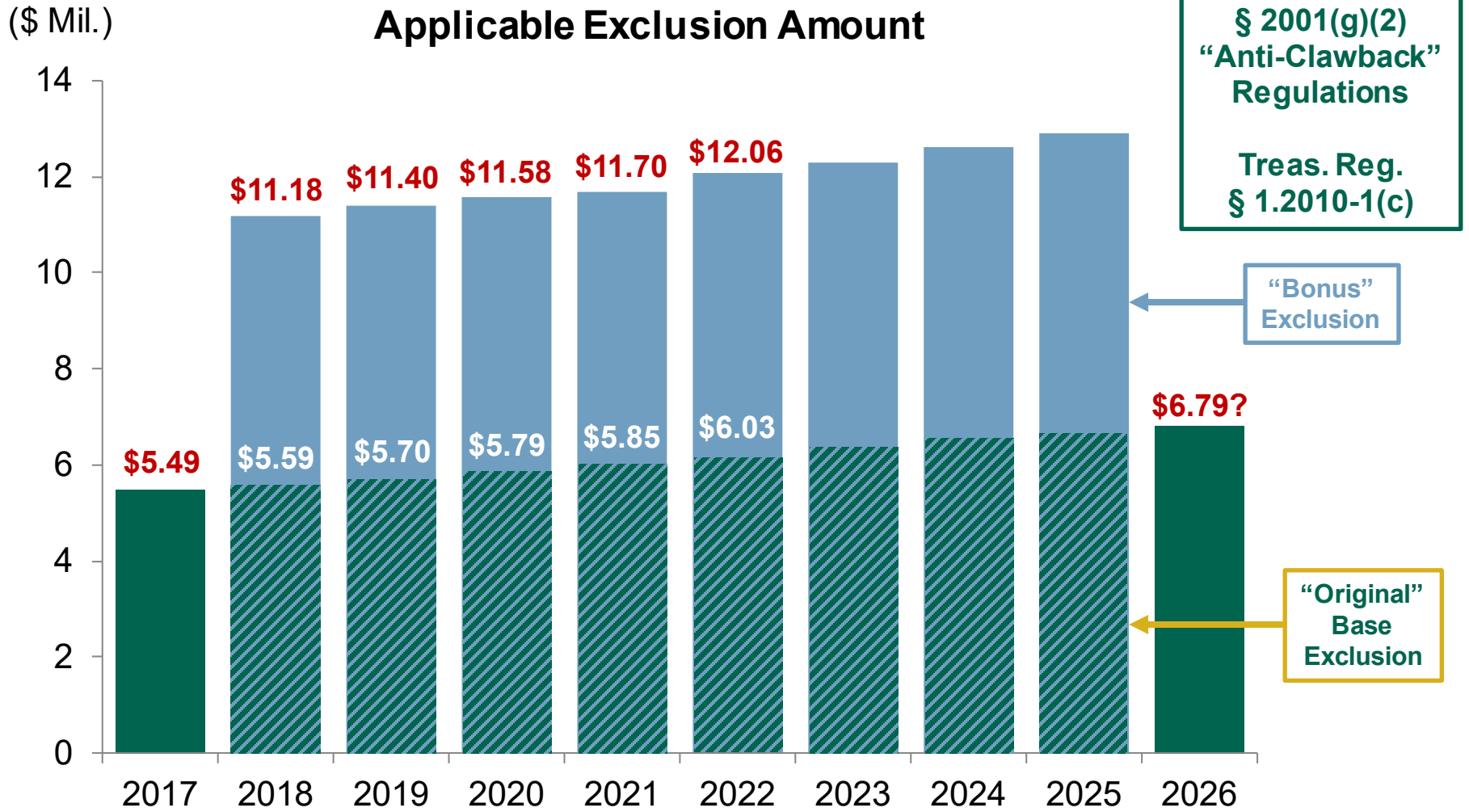


The Transfer Tax Landscape: Venn Diagram





2012 All Over Again?





To Gift or Not to Gift: That's the Question...

Up to Wealthy

\$0 to ~\$12.06 Mil.

- Limit taxable gifts
- Preserve Applicable Exclusion
- Take advantage of free “step-up” in basis
- Limit valuation discounts
- Transfers of wealth in excess of the Applicable Exclusion via “zeroed-out” techniques
- Transfer high basis assets to IDGTs with “swap” power

“Middle Class” Wealthy

~\$12.06 Mil. to ~\$50.0 Mil.

- Taxable gifts in excess of the “Original” Applicable Exclusion depend on whether taxpayer can afford to make such gift
- Careful consideration of “split-gift” election (or NOT) in certain years
- Spousal Lifetime Access Trusts
- Retained cash flow techniques (i.e., preferred partnership freezes)
- Trusts that provide maximum “flexibility”

Ultra-Wealthy

Above ~\$50.0 Mil.

- Large taxable gifts to use “Original” and “Bonus” Applicable Exclusion
- Transfer to IDGTs (with “swap” power)
- Valuation discount planning
- “Zeroed-out” techniques, leveraging taxable gifts (i.e., installment sale)
- “Free-basing” with marital deduction and estate reduction planning with surviving spouse

Consider:

Applicable Exclusion gifts of cash (or marketable securities), and
Exercise of “swap” power in the future.



Some Assets Benefit from “Step-Up”—Some Do Not

“Step-Up” Important
[Higher Valuation]



Asset Type

Tax Characteristic

Creator-Owned Copyrights, Trademarks, Patents & Artwork

Ordinary Transforms to Long-Term

“Negative Basis” Commercial Real Property LPs

Recapture & >100% Long-Term

“Bonus Depreciation” Qualified Property under § 168(k)

§ 1245 Recapture

Oil & Gas Investments

§ 1245 Recapture

Artwork, Gold & Other “Collectibles”

28% Long-Term

Low Basis Stock

20% Long-Term

Roth IRA Assets

Tax Free & No Surcharge

Qualified Small Business Stock (QSBS)

§ 1202 Gain [50, 60, 75 or 100%] Exclusion

High Basis Stock

Minimal Gain

Fixed Income

Typically Minimal Gain

Cash

Basis = Face Value

Passive Foreign Investment Company (PFIC) Shares

No “Step-Up”

Stock at a Loss

Capital Loss Erased

Qualified Opportunity Zone (QOZ) Investments

Converts to IRD

Traditional IRA & Qualified Plan Assets

100% IRD

“Step-Up” not Important
[Lower Valuation]



- Remember the “Freebies”
 - ◆ Annual Exclusion Gifts
 - ◆ Ed/Med Gifts
 - ◆ UGMA / UTMA and Minors Trusts
 - ◆ Section 529 Plans
 - ◆ “Crummey” Trusts (not just for Irrevocable Life Insurance Trusts)

- Default should be a gift to an “Intentionally Defective Grantor Trusts” (IDGTs) with “Swap Power”

- “Defined Value” vs. “Price Adjustment” Clauses

- Carryover Basis under § 1012

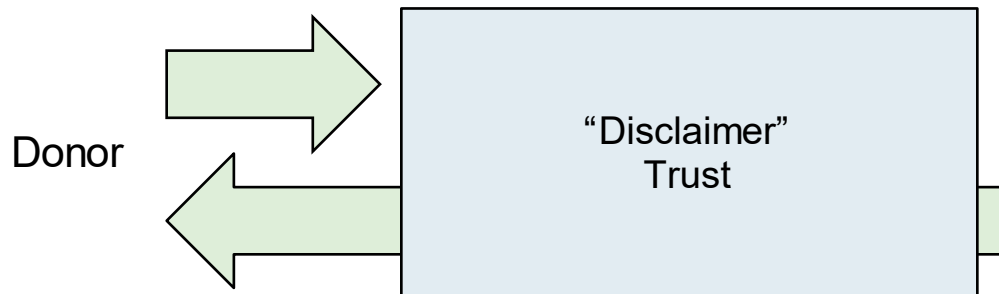
- Valuation Discount Planning
 - ◆ Discount is the wealth equivalent of appreciation out of the estate
 - ◆ Family limited partnership (FLP) transfers
 - ▶ IRS retracted proposed treasury regulations under § 2704 (lapsing rights and restrictions by family)
 - ▶ Challenged under § 2036(a)(2) (retained right in conjunction with any person to designate who could enjoy the property or its income)



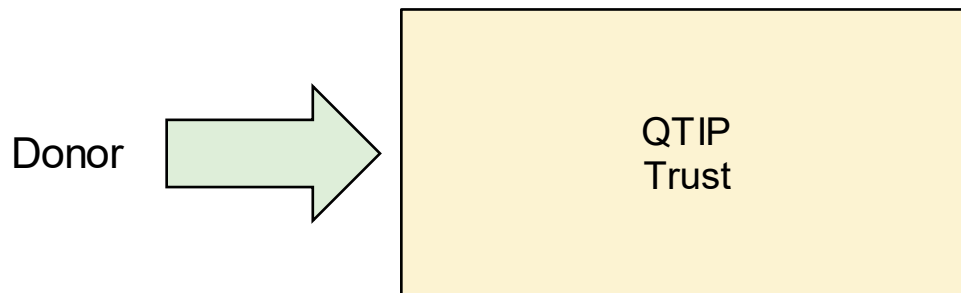
Undoing Gifts: Disclaimer Trusts & QTIP Elections

Reasons to “Undo” Taxable Gifts:

- Current Applicable Exclusion Amount becomes permanent
- Gifted asset depreciates in value
- Loss of “step-up” in basis
- NY donor dies soon after gift (gifts within 3 years of death are subject to NY estate tax but with no corresponding federal estate tax deduction): 49.6% v. 56% effective transfer tax



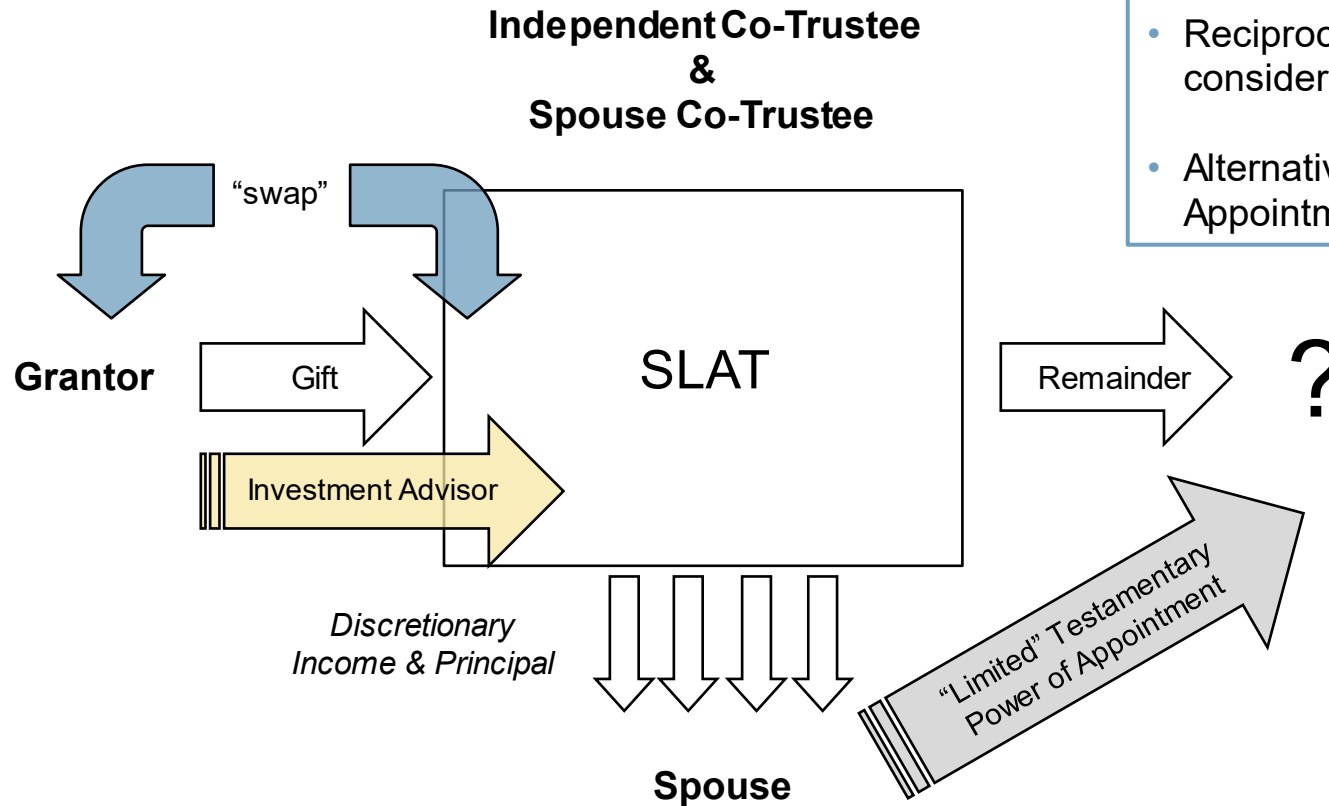
- *Trust provides if beneficiary disclaims interest in trust, property is returned to donor.*
- *If a qualified disclaimer (9 months), not a taxable gift*



If, before due date of the donor’s gift tax return (April 15 or October 15), donor makes § 2523(f) QTIP election on gift tax return, transfer covered by the marital deduction and not a taxable gift that reduces Applicable Exclusion Amount



Spousal Lifetime Access Trust



- Applicable state law on donor's creditor claims critical to know
- Reciprocal trust doctrine considerations (Grace or Levy)
- Alternative: Special Power of Appointment Trust (SPAT)



Net Gifts? Financed Net Gifts? Net, Net Gift?

Net Gift

$$\frac{\text{Tentative Tax}}{1 + \text{Rate of Tax}} = \frac{\$1,000,000 \times 40\%}{1 + 40\%} = \$285,714$$

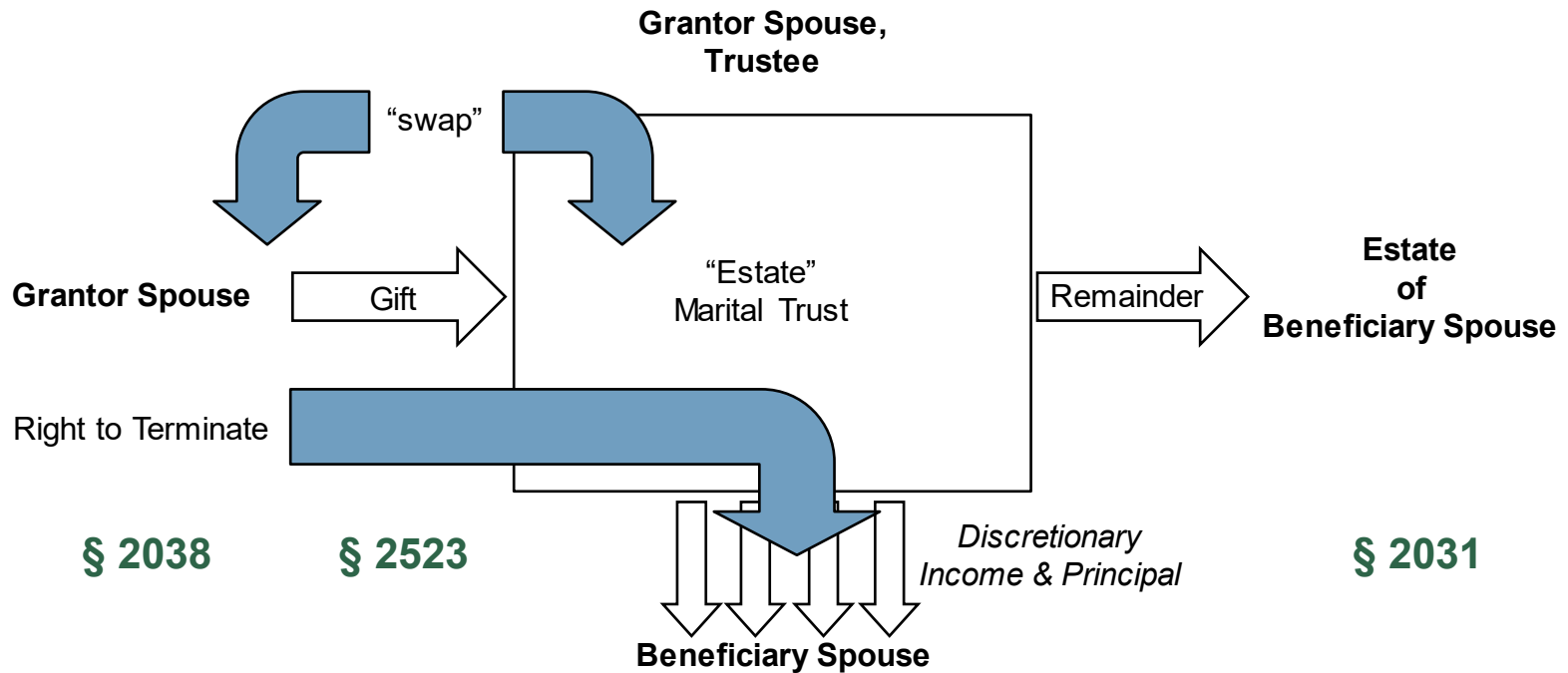
Financed Net Gift





Don't Forget About Inter-Vivos Marital Deduction Trusts

- Qualified Terminable Interest Property (QTIP) Marital Trust
- General Power of Appointment Marital Trust
- “Estate” Marital Trust
- Section 2038 Estate Marital Trust



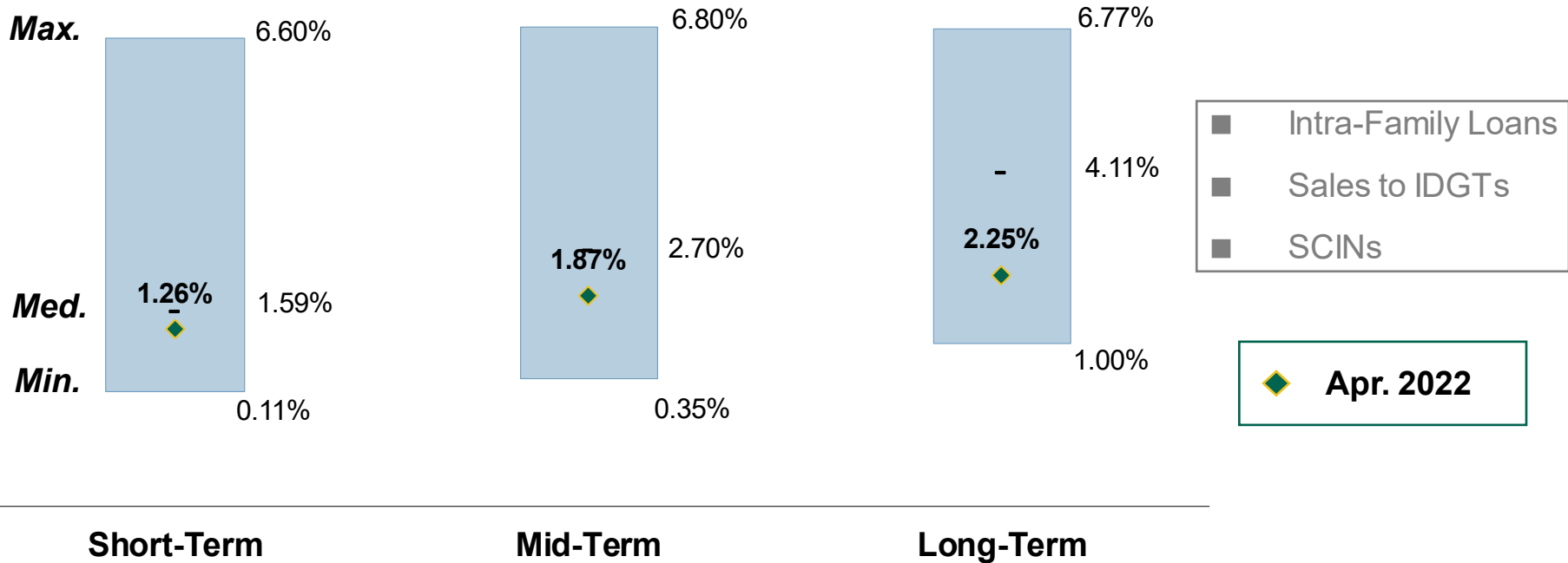


*QPRTs, GRATs, and
The Fundamentals of Sales to
Grantor Trusts*



AFRs Are Low

Applicable Federal Rates Jan. 1998 – Apr. 2022

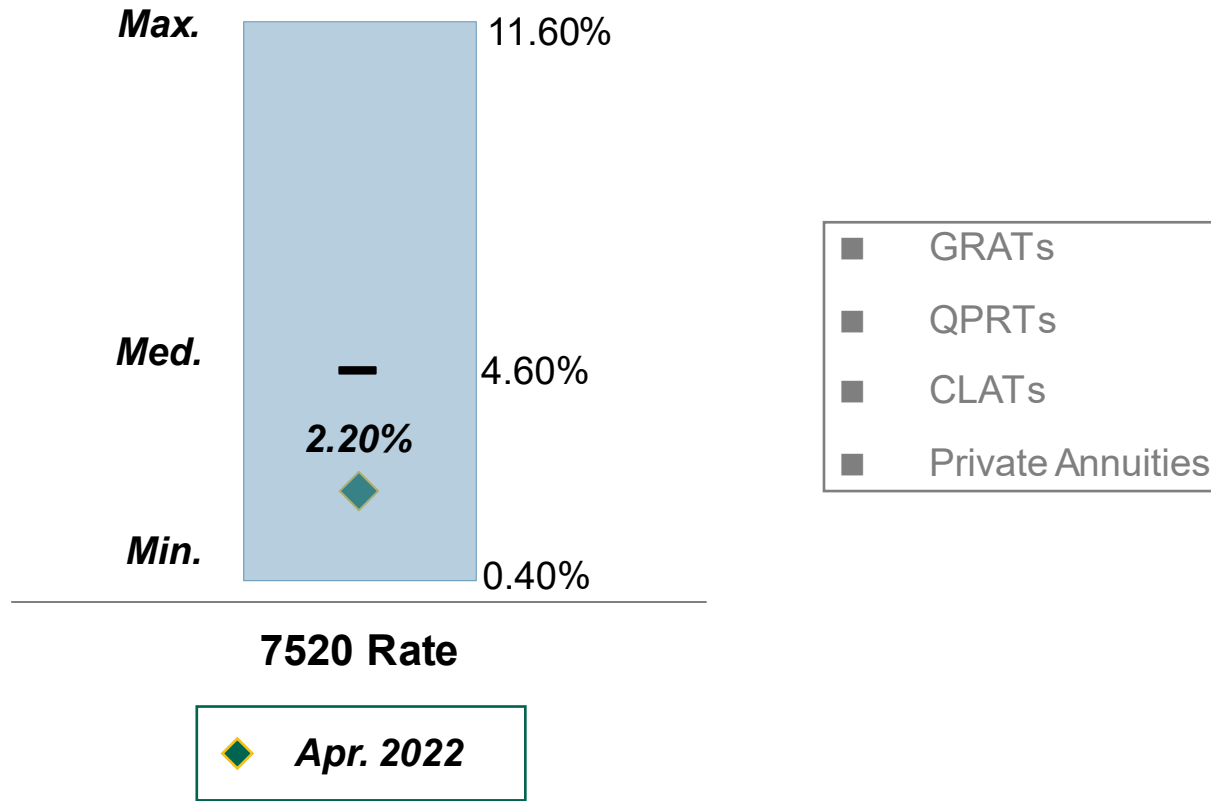


- Refinancing may require consideration.
- Consider prepaying debt and replace with new promissory note.
- Remember term of note should not be longer than life expectancy of holder.



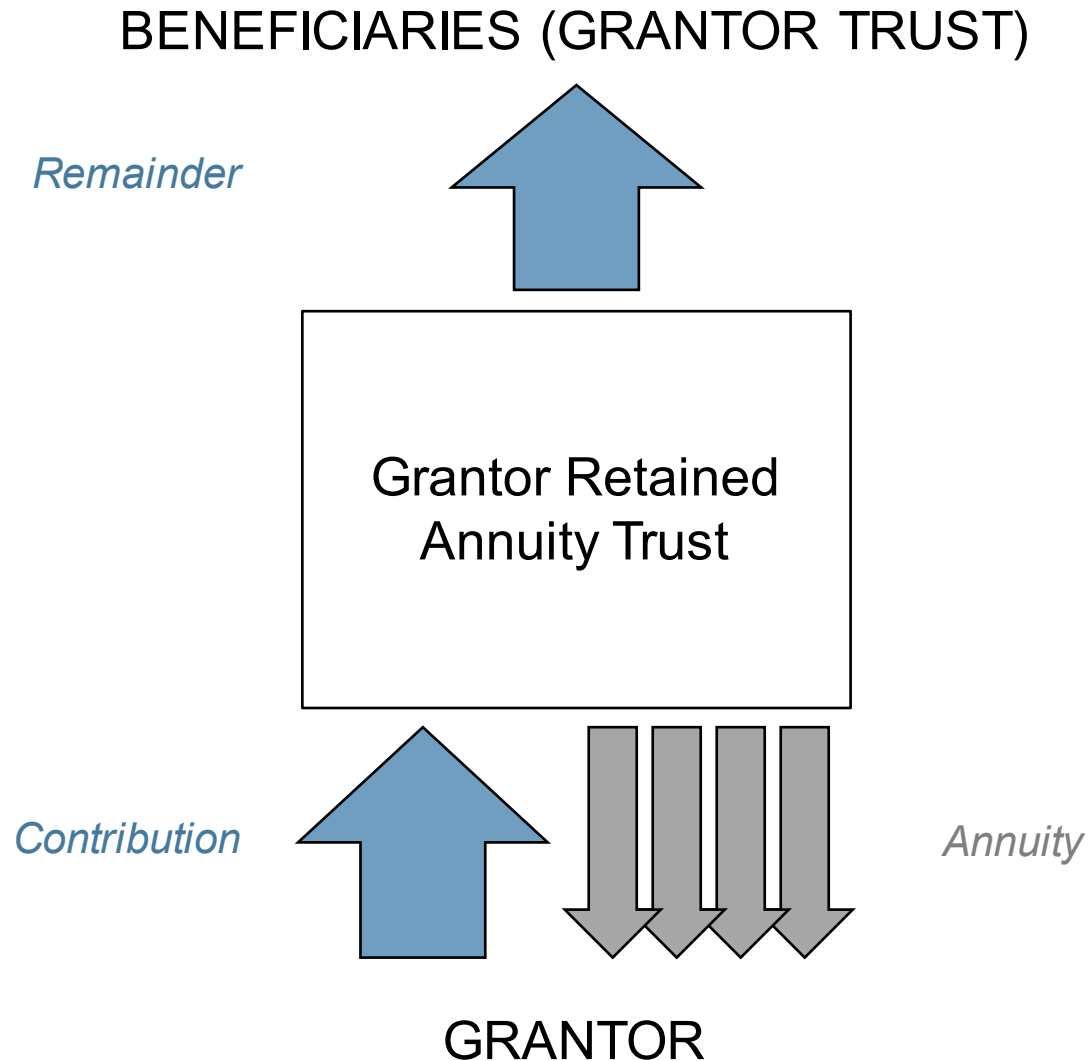
Low Section 7520 Rate

Section 7520 Rate (Since Inception) Mar. 1989 – Apr. 2022



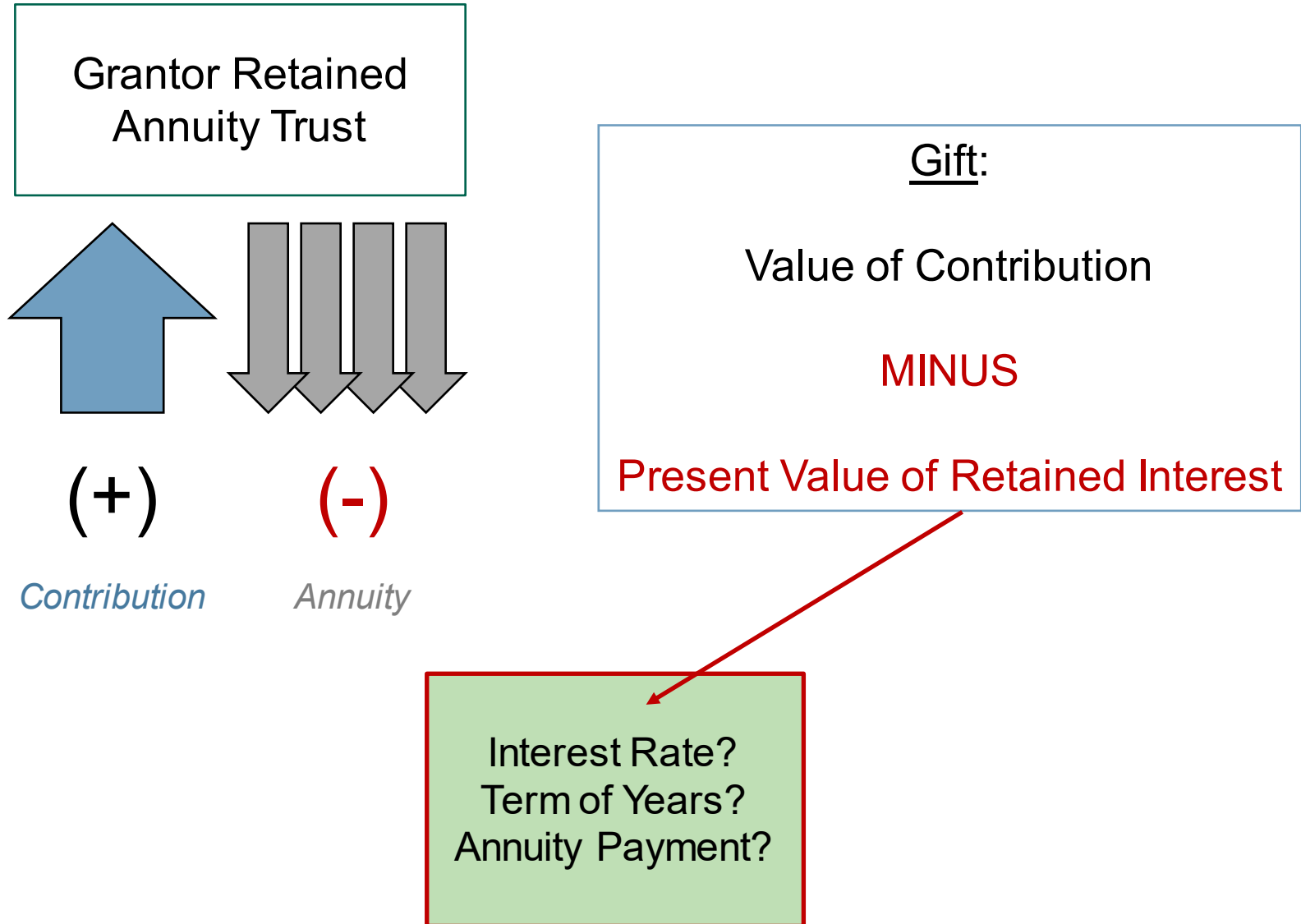


Grantor Retained Annuity Trusts





Calculation of the Taxable Gift





“Zeroed-Out” GRAT: Fixed Annuity

**7520 Rate of 6.0%
10 Year Term
\$10 Mil. Contribution**

Fixed Annuity

- 1. \$1,358,680
- 2. \$1,358,680
- 3. \$1,358,680
- 4. \$1,358,680
- 5. \$1,358,680
- 6. \$1,358,680
- 7. \$1,358,680
- 8. \$1,358,680
- 9. \$1,358,680
- 10. \$1,358,680

Total: \$13,586,800

Present Value = \$10,000,000

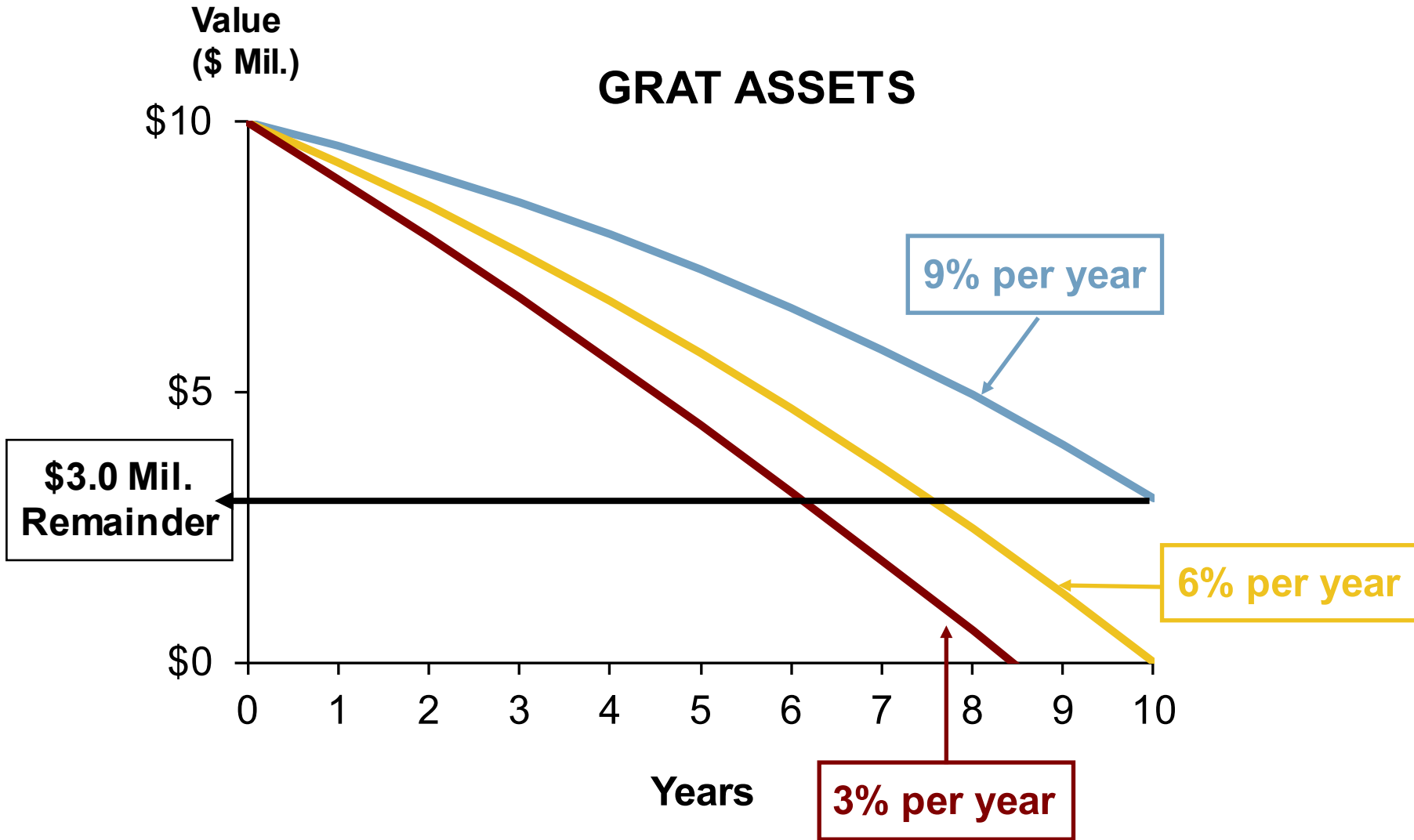


Amount to Grantor



7520 Rate: Assumed Rate of Return

GRAT ASSETS





Returns Are Rarely Average

	<u>Average Return</u>	<u>Return Path 1*</u>	<u>Return Path 2*</u>
Year 1	9.3%	10.1%	-22.1%
Year 2	9.3	1.3	-11.9
Year 3	9.3	37.6	-9.1
Year 4	9.3	23.0	21.0
Year 5	9.3	33.4	28.6
Year 6	9.3	28.6	33.4
Year 7	9.3	21.0	23.0
Year 8	9.3	-9.1	37.6
Year 9	9.3	-11.9	1.3
Year 10	9.3	-22.1	10.1
CAGR	9.3%	9.3%	9.3%

*Return Path 1 represents the annual return of the S&P 500 from 1993-2002 and Return Path 2 is the reverse of the returns.



Path Returns Is Equally As Important

- \$10 Million GRAT
 - 10 Years
 - \$1,358,680 Annuity

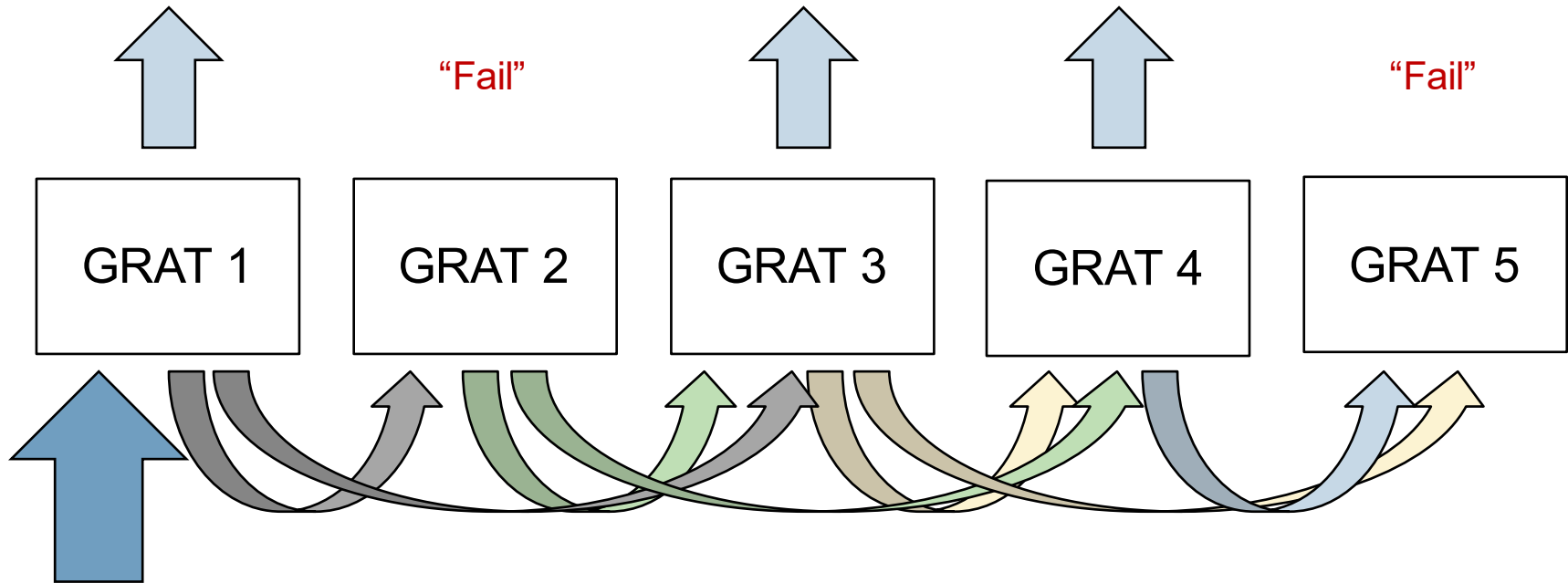
	Grantor	Remainder
Average Return	\$13.6 Mil.	\$ 3.4 Mil.
Return Path 1	\$13.6	\$ 8.0
Return Path 2	\$ 8.0	\$ 0.0

“FAIL”



Short-Term (2-Year) “Zeroed-Out Rolling” GRATs

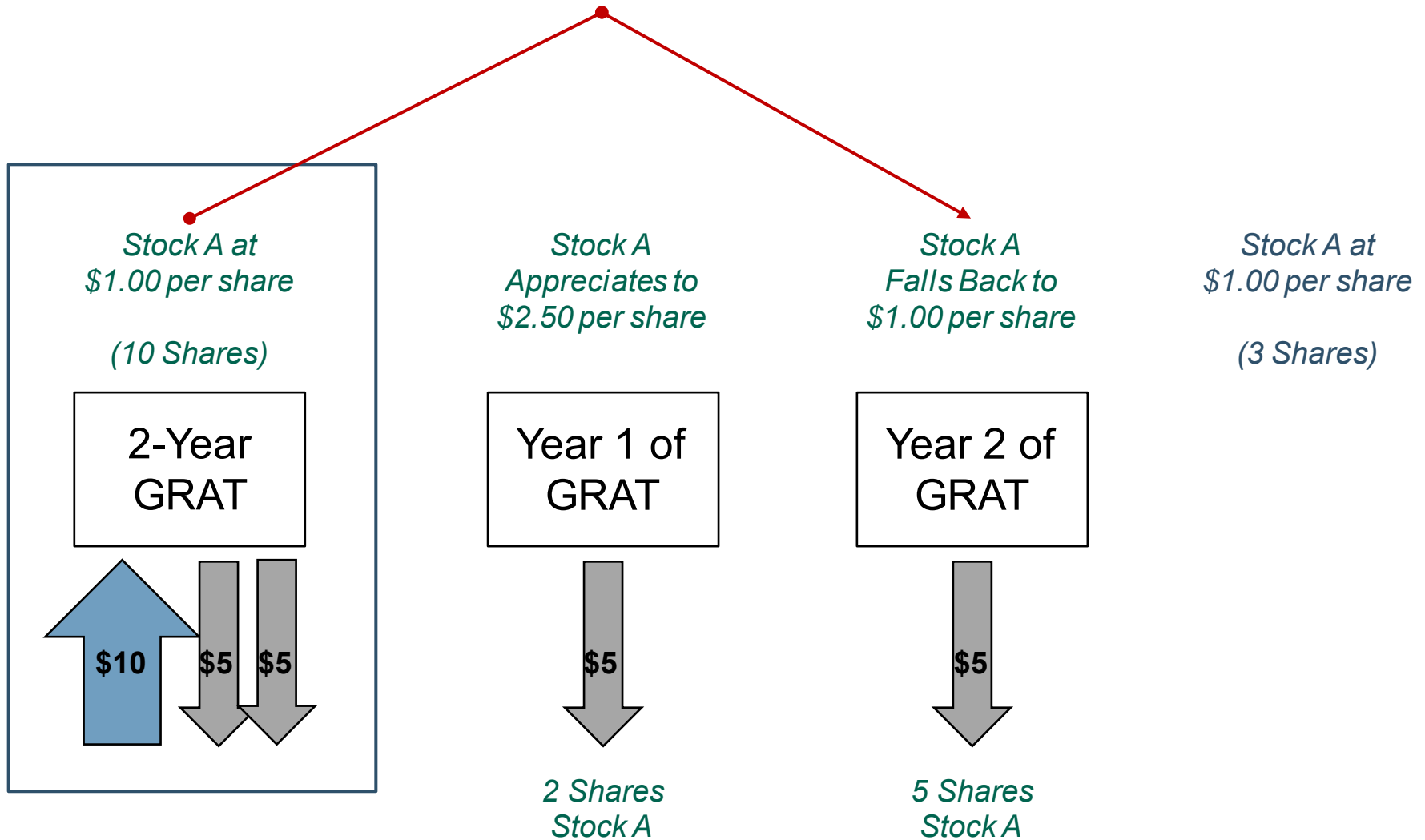
BENEFICIARIES (GRANTOR TRUST)



GRANTOR



Short-Term GRATs Are About Volatility (Not Return or 7520 Rate)





Additional Things About GRATs

- Qualified Annuity Payments
 - ◆ Commutation (prepayment) of term holder's interest is prohibited
 - ◆ May increase by no more than 20% than the previous year's payment
 - ◆ Annuity payment may not be paid by a note, debt instrument, option, or other similar financial arrangement

- GRAT is subject to Estate Tax Inclusion Period (ETIP) rules for GST tax purposes

- GRITs are still possible for the benefit of nieces and nephews

- Estate tax inclusion amount is not necessarily the value of the assets in the GRAT at the time of death

- Allowable or Possible Planning
 - ◆ GRAT can borrow from third party to pay annuity
 - ◆ "Locking" GRAT value by "swapping" assets including grantor's promissory note
 - ◆ Multiple GRATs taking "long" and "short" investment positions or "preferred" and "common" interests
 - ◆ Sale of remainder interest to another trust (e.g., GST exempt IDGT)
 - ◆ Remainder can vest in a limited liability company



What About Very Long-Term GRATs?

50 Year GRAT

Annuity	\$331,757.22
7520 Rate	2.2%
Years	50
PV of Grantor's Retained Interest	\$10,000,000
Annuity Factor	30.14252399
Life Factor	0.663135528
Remainder Factor	0.336864472

7520 Rate at Death	§ 20.2036-1(c)(2) Inclusion
1.0%	\$ 33,175,722
2.0%	\$ 16,587,861
3.0%	\$ 11,058,574
4.0%	\$ 8,293,931
5.0%	\$ 6,635,144
6.0%	\$ 5,529,287
7.0%	\$ 4,739,389

GRAT Asset Value	
Years	Annual Return 7%
5	\$ 12,117,668
10	\$ 15,087,807
15	\$ 19,253,581
20	\$ 25,096,294
25	\$ 33,291,001

60 Year GRAT

Annuity	\$301,777.31
7520 Rate	2.2%
Years	60
PV of Grantor's Retained Interest	\$10,000,000
Annuity Factor	33.13701708
Life Factor	0.729014376
Remainder Factor	0.270985624

7520 Rate at Death	§ 20.2036-1(c)(2) Inclusion
1.0%	\$ 30,177,731
2.0%	\$ 15,088,866
3.0%	\$ 10,059,244
4.0%	\$ 7,544,433
5.0%	\$ 6,035,546
6.0%	\$ 5,029,622
7.0%	\$ 4,311,104

GRAT Asset Value	
Years	Annual Return 7%
5	\$ 12,290,075
10	\$ 15,502,023
15	\$ 20,006,947
20	\$ 26,325,335
25	\$ 35,187,202

70 Year GRAT

Annuity	\$281,326.46
7520 Rate	2.2%
Years	70
PV of Grantor's Retained Interest	\$10,000,000
Annuity Factor	35.5458926
Life Factor	0.782009637
Remainder Factor	0.217990363

7520 Rate at Death	§ 20.2036-1(c)(2) Inclusion
1.0%	\$ 28,132,646
2.0%	\$ 14,066,323
3.0%	\$ 9,377,549
4.0%	\$ 7,033,161
5.0%	\$ 5,626,529
6.0%	\$ 4,688,774
7.0%	\$ 4,018,949

GRAT Asset Value	
Years	Annual Return 7%
5	\$ 12,407,682
10	\$ 15,784,581
15	\$ 20,520,857
20	\$ 27,163,728
25	\$ 36,480,699



Long-Term GRATs with a Bonus Exclusion Gift

\$10 Mil. Contribution - \$3.97 Mil. Retained Annuity = \$6.03 Mil. Taxable Gift

50 Year GRAT

Annuity	\$131,707.62
7520 Rate	2.2%
Years	50
PV of Grantor's Retained Interest	\$ 3,970,000
Annuity Factor	30.14252399
Life Factor	0.663135528
Remainder Factor	0.336864472

7520 Rate at Death	§ 20.2036-1(c)(2) Inclusion
1.0%	\$ 13,170,762
2.0%	\$ 6,585,381
3.0%	\$ 4,390,254
4.0%	\$ 3,292,690
5.0%	\$ 2,634,152
6.0%	\$ 2,195,127
7.0%	\$ 1,881,537

GRAT Asset Value	
Years	Annual Return 7%
5	\$ 13,268,101
10	\$ 17,851,782
15	\$ 24,280,632
20	\$ 33,297,426
25	\$ 45,943,946

60 Year GRAT

Annuity	\$119,805.59
7520 Rate	2.2%
Years	60
PV of Grantor's Retained Interest	\$ 3,970,000
Annuity Factor	33.13701708
Life Factor	0.729014376
Remainder Factor	0.270985624

7520 Rate at Death	§ 20.2036-1(c)(2) Inclusion
1.0%	\$ 11,980,559
2.0%	\$ 5,990,280
3.0%	\$ 3,993,520
4.0%	\$ 2,995,140
5.0%	\$ 2,396,112
6.0%	\$ 1,996,760
7.0%	\$ 1,711,508

GRAT Asset Value	
Years	Annual Return 7%
5	\$ 13,336,547
10	\$ 18,016,226
15	\$ 24,579,718
20	\$ 33,785,355
25	\$ 46,696,738

70 Year GRAT

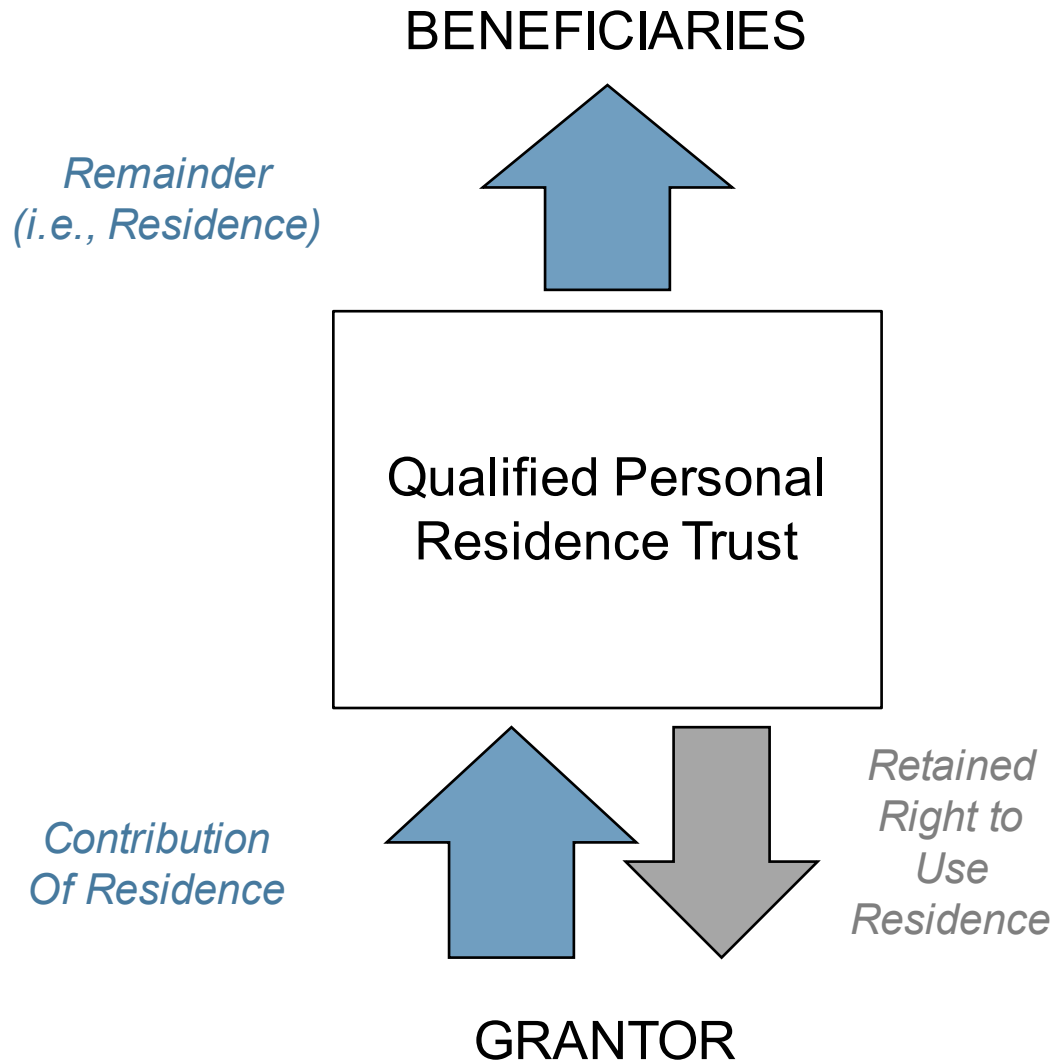
Annuity	\$111,686.60
7520 Rate	2.2%
Years	70
PV of Grantor's Retained Interest	\$ 3,970,000
Annuity Factor	35.5458926
Life Factor	0.782009637
Remainder Factor	0.217990363

7520 Rate at Death	§ 20.2036-1(c)(2) Inclusion
1.0%	\$ 11,168,660
2.0%	\$ 5,584,330
3.0%	\$ 3,722,887
4.0%	\$ 2,792,165
5.0%	\$ 2,233,732
6.0%	\$ 1,861,443
7.0%	\$ 1,595,523

GRAT Asset Value	
Years	Annual Return 7%
5	\$ 13,383,237
10	\$ 18,128,401
15	\$ 24,783,740
20	\$ 34,118,197
25	\$ 47,210,256



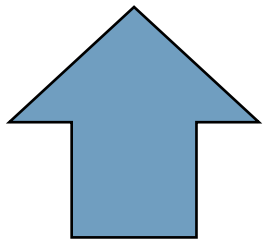
Qualified Personal Residence Trusts





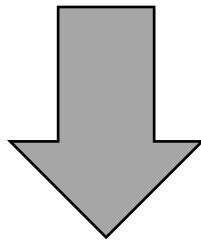
Calculation of the Taxable Gift

Qualified Personal
Residence Trust



(+)

Contribution



(-)

Retained Use

Gift:
Value of Contribution
MINUS
Present Value of Retained Interest

Interest Rate?
Term of Years?
Age of Interest Holder?



No “Zeroed-Out” Gifts with QPRTs

Resulting Taxable Gift 50-Year Old Grantor \$1.0 Mil. Residence/Contribution		
Term	1.0% 7520 Rate	6.0% 7520 Rate
10 Years	\$847,290	\$522,620
20 Years	\$654,950	\$249,180
30 Years	\$402,860	\$94,540
40 Years	\$132,560	\$19,190
50 Years	\$9,600	\$860



Additional Things About QPRTs

- Commutation of term holder's interest is prohibited

- Limitations to QPRTs
 - ◆ Residence may not be purchased by grantor or grantor's spouse during term or after term
 - ◆ Fair market value rent must be paid to owners after expiration of the term

- Sale of residence with no intent to repurchase will convert QPRT to GRAT

- Personal residence
 - ◆ Includes interest holder's principal place of business
 - ◆ Can be rented when interest holder is not occupied by interest holder
 - ◆ Can be used rent free by family members

- Possible to cause estate tax inclusion (and "step-up" in basis) on QPRT assets

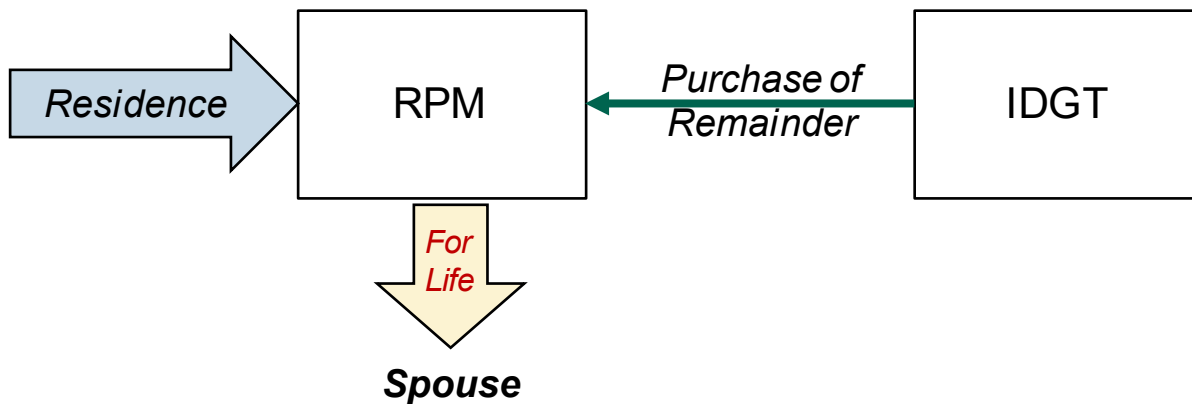
- Alternatives to QPRTs include:
 - ◆ Joint split-interest purchase
 - ◆ Remainder Purchase Marital Trust



QPRT vs. RPM

QPRT: Resulting Taxable Gift 50-Year-Old Grantor \$1.0 Mil. Residence	
Term	2.2% 7520 Rate
10 Years	\$752,900
20 Years	\$517,150
30 Years	\$282,660
40 Years	\$82,650
50 Years	\$5,320

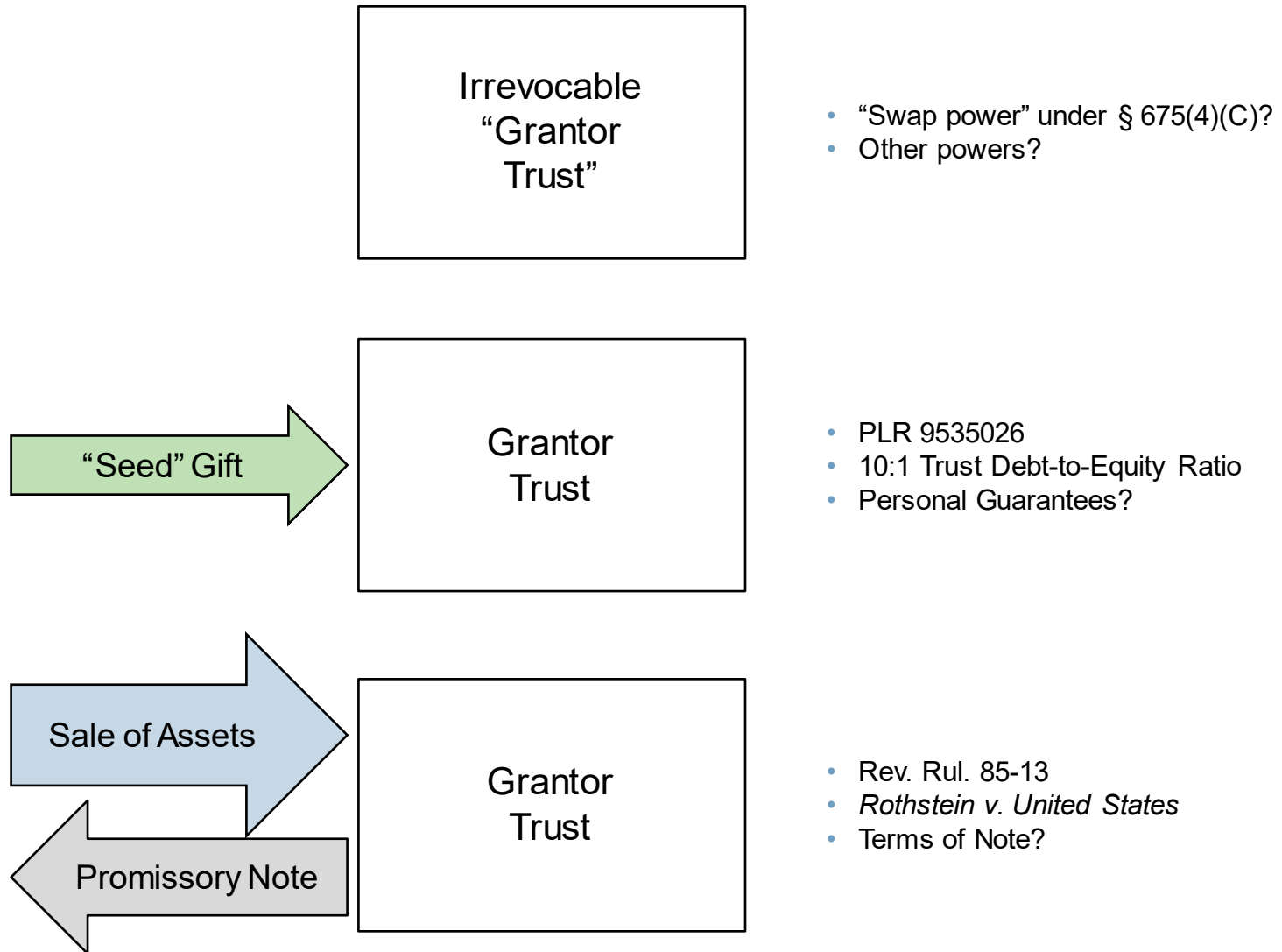
RPM: Remainder Value 50-Year-Old Spouse \$1.0 Mil. Residence	
Term	2.2% 7520 Rate
Life	\$538,880
Life or 20 Years	\$671,610
Life or 30 Years	\$584,550
Life or 40 Years	\$546,360
Life or 50 Years	\$539,130



- No QPRT Restrictions On:**
- Multiple personal residences
 - Sale of residence to grantor, spouse, or grantor trust
 - Use of residence (rental)
 - Additional property by gift or sale
 - Use of sale or insurance proceeds



Installment Sales to IDGTs





The Valuation of Promissory/Installment Notes in the Future?

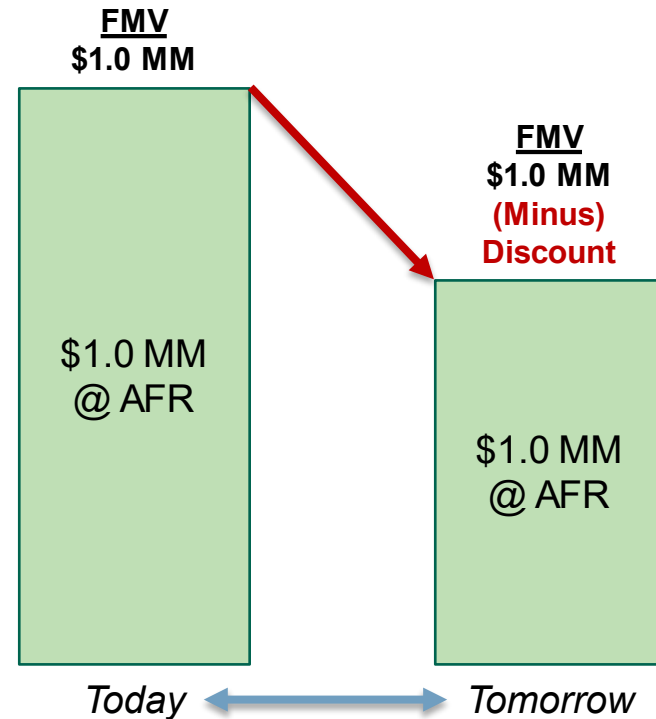
“In the case of an entity engaged in an active trade or business, at least 60 percent of whose value consists of the nonpassive assets of that trade or business, and to the extent that the liquidation proceeds are not attributable to passive assets within the meaning of section 6166(b)(9)(B), such proceeds may include such a note or other obligation if such note or other obligation is adequately secured, requires periodic payments on a non-deferred basis, is issued at market interest rates, and has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds.” Prop. Treas. Reg. 25.2704-3(b)(iv).

Loans and Installment Sales Today

- ◆ Applicable federal rate (long-term, not short or mid-term);
- ◆ 10% (or less) equity;
- ◆ No prepayment penalty; and
- ◆ Adequate security not required.

Promissory Notes Will Need to Be:

- ◆ Adequately secured;
- ◆ Requires periodic payments on a non-deferred basis;
- ◆ Issued at market interest rates; and
- ◆ Has a fair market value equal to the liability.



Using Notes to Avoid Section 2036 Issues:

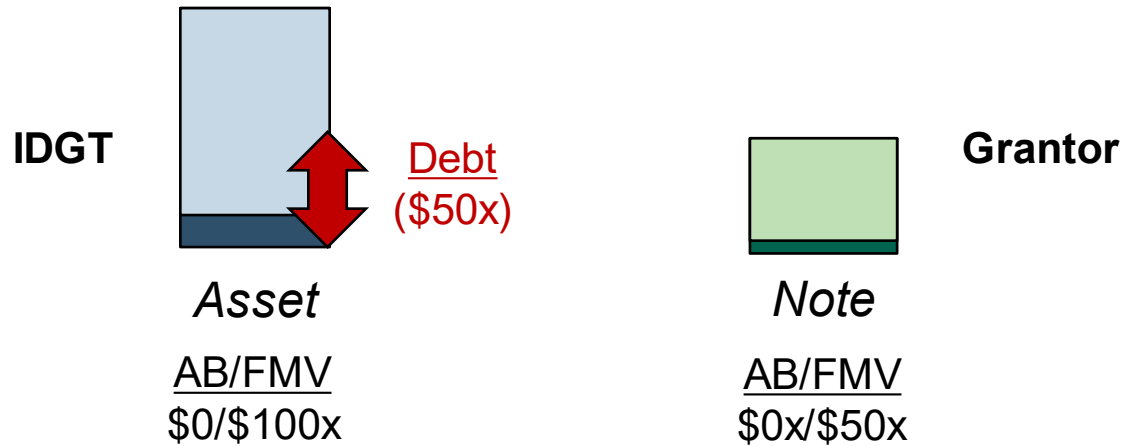
- 1: Sell Family-Owned Entity to IDGT for FMV in Exchange for Installment Note.
- 2: Gift the Installment Note to IDGT (Borrower).



*Eliminating Outstanding Installment Notes,
Avoiding Gain At Death, And
Getting A “Step-Up” On The IDGT Property*



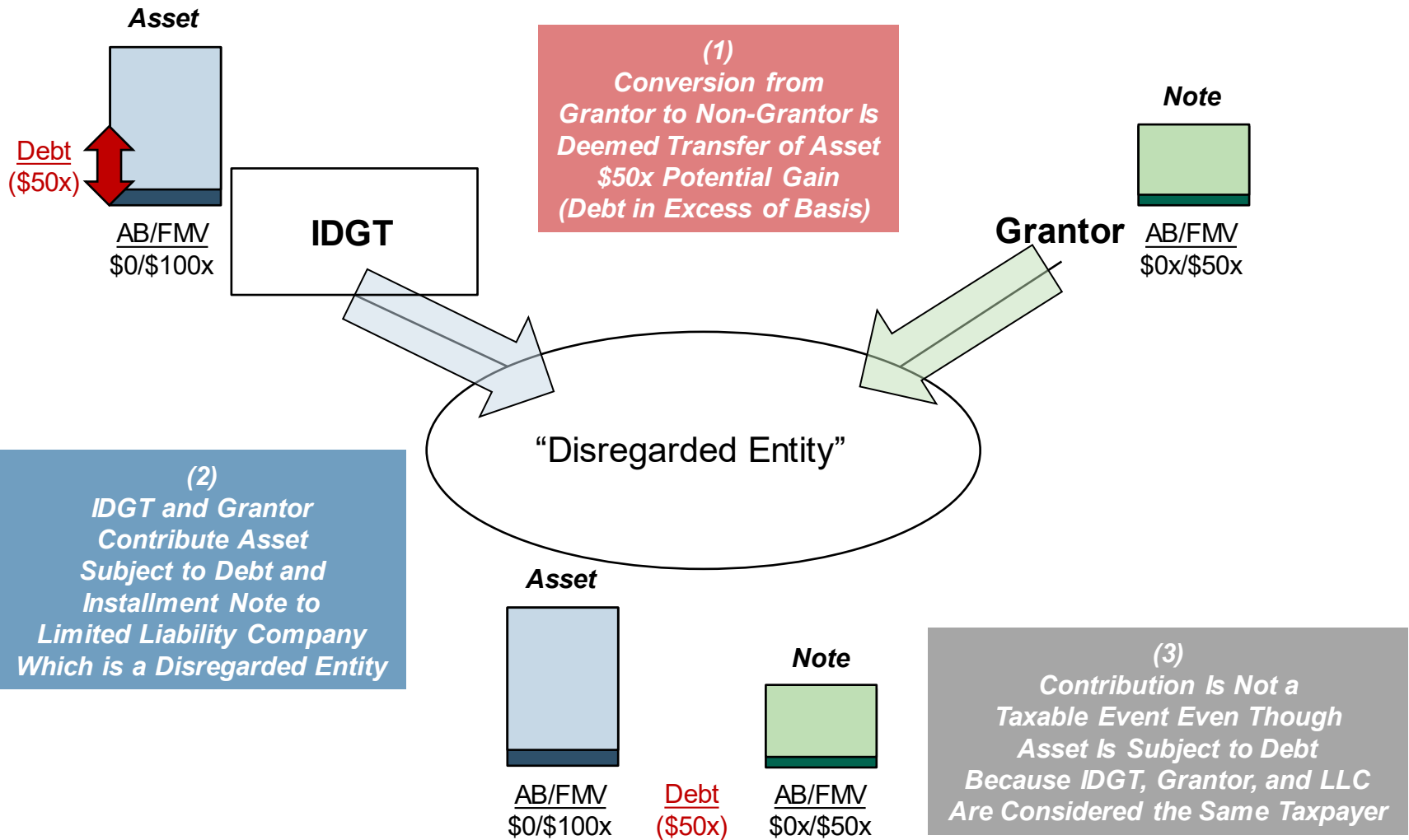
Installment Sale to IDGT and Outstanding Note



***Potential \$50x Taxable Gain
Upon Conversion of
Grantor Trust to Non-Grantor Trust***

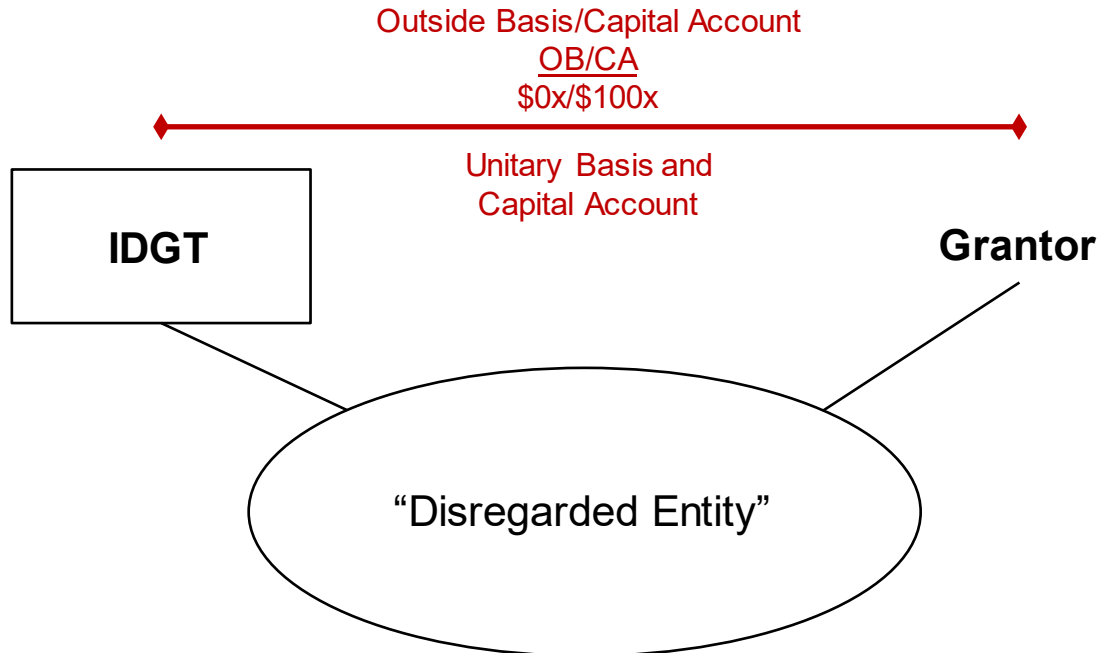


Making the Debt Disappear with a Disregarded Entity

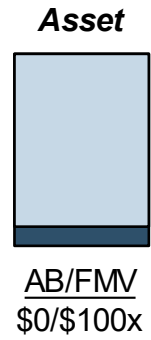




Debt “Merges” and Disappears: Non-Taxable Event

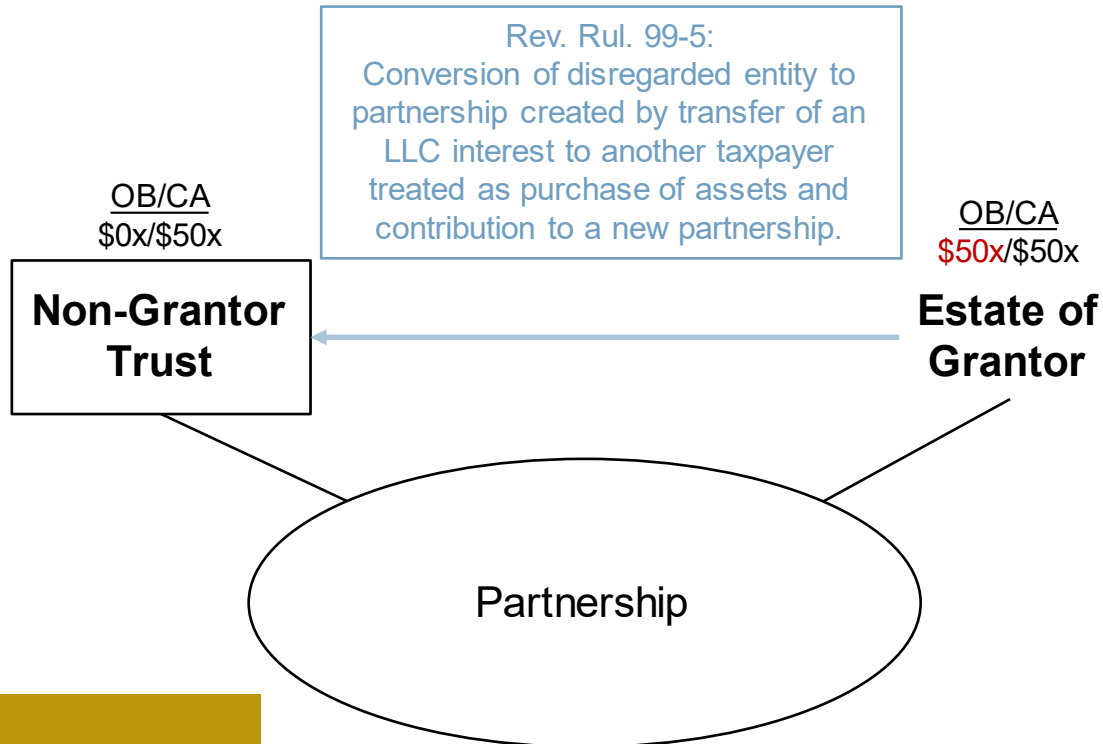


(4)
*Debt Obligation and the Note
“Merge” and the Debt is Deemed
Extinguished. No Cancellation of
Indebtedness Because IDGT, Grantor, and
LLC Are Considered the Same Taxpayer*

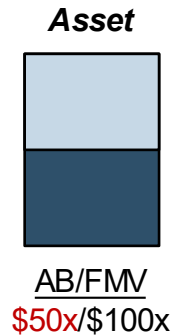




Death of Grantor: Disregarded Entity to a Partnership



(5)
Grantor's Death Converts the LLC to a Partnership for Tax Purposes. Treated as the Creation of a New Partnership: Grantor's Portion of the Asset Gets a "Step-Up" in Basis and Is Contributed to a Newly Formed Partnership.



- (6)
End Results:
- a) *No Gain on the Grantor's Death;*
 - b) *Asset in IDGT Gets a Partial Basis Adjustment under § 1014; and*
 - c) *No Installment Note Included in Grantor's Estate.*



Disclosures

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