Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1447

Date: 16-Apr-09
From: Steve Leimberg's Estate Planning Newsletter
Subject: Interesting Interest Rate Questions

"*The answer my friend,*
is blowing in the wind,
the answer is blowing in the wind"

– or *is* it?

With the Applicable Federal Rates ("AFR") under Section 1274 (d) at historical lows (see http://www.leimberg.com/freeResources/keyRates.asp), it's no secret that many estate planning practitioners are recommending that clients enter into freeze transactions, or engage in the restructuring thereof, to maximize the benefits for their clients. (See Keith Buck and Fred Chang's Estate Planning Tripple Witching Hour is Upon Us, Estate Planning Newsletter 1445.)

In this fascinating (and certain to be provocative) commentary, **Jerry Hesch** and **Alan Gassman,** provide **LISI** members with special insights into interest rate issues - that must be *carefully* thought through.[1]

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LISI wants to express particular thanks to **Steve Gorin**, Technical Editor for his thoughts on this most important issue.

EXECUTIVE SUMMARY:

With the March 2009 AFRs being slightly higher than the February 2009 AFRs, some estate planning professionals assume

that the minimum interest rate[2] can *only* be the AFR in effect for the month of the installment sale transaction, or the month that the interest rate for a prior installment sale is reset.

Although using the lower of the AFR for the month of the event or the AFR for the two *prior* months[3] as the minimum interest rate has been mentioned as a possibility for new installment sales to grantor trusts and restructuring prior installment notes,[4] those who have addressed this possibility have said that the AFR for the prior two months can*not* be used. But they have not cited any authority for their conclusions, or at best say that "the answer is not clear".

The use of lowest AFR of the three months including the month in which the event occurs and the two preceding months can be advantageous by allowing the selection of a *lower* interest rate than the current month's AFR. For example, the mid-term rate that can apply to a 9-year Note was 1.64% in February, 1.93% in March and is 2.14% in April.

Another concern arises where donors who have successfully shifted wealth to family trusts or other family entities for junior family members that are not exposed to the gift or estate taxes now find that they are in a financial position where they need to borrow from these family trusts or other family entities.[5]

A *very* important question in the analysis is as follows:

"If loans made by a family trust or other family entity back to the senior family member use rates of interest based upon the AFR, will the use of an interest rate that is lower than market rates[6] create exposure to the inclusion of these trusts or other entities in the senior family member's gross estate under Sections 2036(a) and 2038?"

FACTS:

WHAT IS THE MINIMUM INTEREST RATE THAT MAY BE USED?

The Internal Revenue Code provides the answer to the question whether the minimum interest rate for the month of a sale or refinancing can be based upon the lower of the Applicable Federal Rate for that month or the Applicable Federal Rate for either of the preceding two months.

Because Section 1274 is located in that portion of the Internal Revenue Code providing the OID rules[7] for transactions that are treated as realization events for Federal income tax purposes, several commentators have concluded that Section 1274 *only* applies to deferred payment sales that are income tax realization events under Section 1001(a).

Some commentators have concluded that since an installment sale to a grantor trust is "disregarded" for income tax purposes, there is

no "sale or exchange" for purposes of Section 1274.[8] By assuming that Section 1274(d) *only* applies to installment sales that are income tax realization events, their conclusion would be that using the lower AFR over a 3-month period under Section 1274(d) is not possible.

But then, they conclude that the Section 1274(d) AFR for the current month would *have* to apply.

INTERPLAY BETWEEN SECTIONS 7872 & 1274

Section 7872 is located in Subchapter C of Chapter 80 of the Internal Revenue Code. Given the heading of Subchapter C (Provisions affecting more than one subtitle), it is clear that Section 7872 applies to the gift, estate and income tax subtitles. [9]

Moreover, the language in Section 7872 makes it clear that it affects *both* the income taxes *and* the gift taxes. Section 7872(a) states that it apples "for purposes of this title."

That title is Title 26 of the United States Code, which is the *entire* Internal Revenue Code. Now, look carefully at the interest rates that Section 7872 incorporates for *all* purposes. Section 7872(f)(2)(A) incorporates by reference the interest rates in Section 1274(d).

Using this analysis, the minimum interest rates for transactions that are disregarded for income tax purposes (such as a sale to a grantor trust) are still the Section 1274(d) rates.

Thus, in our opinion, one *can* use the AFR for the current month *or* either of the AFRs for the prior two months.

The estate planning professionals who have questioned whether Section 1274(d) rates can be used for installment sales to grantor trusts have missed this point.[10]

The language in Section 7872 makes it clear, at least to the authors, that Section 1274(d) applies in the context of any "sale or exchange" considered to have occurred for income tax, gift tax, or estate tax purposes. Section 7872 must be applied in deciding whether a loan arrangement is considered to be a gift for gift tax purposes.[11]

Section 7872(f)(2)(A) specifically states that in the case of a term loan "the applicable Federal Rate shall be the applicable Federal Rate in effect under Section 1274(d) 'as of the date on which the loan was made,' compounded semiannually."

The words "as of the day on which the loan was made" refers to the applicable Federal rate determination process under Section 1274(d), which includes the lowest 3-month rate sub-provision referred to under Section 1274(d)(2).

If this were not the case, then the application of Section 1274(d)(2) would have been explicitly limited to "income taxable" sales or exchanges.

This is the position that the IRS took in *Frazee v. Commissioner* [12] when it required that the rates prescribed in Section 1274 (d) must be used in determining the value of an installment note for gift tax purposes under Section 7872. Because the Tax Court concurred, Frazee v. Commissioner is judicial authority for the use of the Section 1274(d) AFRs in valuing installment notes for the gift tax.

WHAT HAPPENS WHEN THE INTEREST RATE ON AN *EXISTING* LOAN IS REDUCED?

Obviously, many loans in effect from prior years have interest rates higher than the current level of AFRs. Since the objective is to shift wealth to junior family members, or to trusts for junior family members, one would want these intra-family loans to provide the *minimum* interest rates that the IRS will accept.

The consensus seems to be that, if the maker of the term loan has the ability to prepay principal, it should not be considered a gift if the parties renegotiate to provide that in lieu of being prepaid, the payee accepts a reduction of the interest rate to the now lower Applicable Federal Rate.[13] This is common between borrowers and commercial lenders when interest rates go down.

There has been some confusion in restructuring existing loans and installment notes because the commentary, and even some of the published articles, have not clearly differentiated the discussion between loans made to grantor trusts and loans made to individuals or entities that are treated as separate tax persons for Federal income tax purposes.

If the loan is between the grantor and the grantor trust, there is no loan for income tax purposes.[14] Thus, many of the income tax realization concerns are irrelevant. However, for *gift* tax purposes, the loan by the grantor to the grantor trust is a loan. Thus, it is possible that the reduction in the interest rate of a term loan would be considered a gift tax transfer when a term loan interest rate is reduced.

The authors believe that a "sale or exchange" for the purposes of Section 1274(d) may be considered to occur where the interest rate of a note is reduced, thus permitting the parties to select the *lowest* AFR over a 3-month period under Section 1274(d).

By analogy, the new Section 108(i) rule for deferral of income from discharge of indebtedness by an individual in a trade or business specifically refers to the deferral being applicable where there is an exchange of the debt instrument for another debt instrument.[15]

Section 108(i) further states that an exchange of the debt instrument for another debt instrument includes an exchange resulting from the modification of a debt instrument.

Under the above rationale, where the interest rate of a note is reduced, the note may be considered as exchanged for another note of different terms, or any of the note terms are modified, a "sale or exchange" for the purposes of Section 1274(d) may have occurred and the parties can use the most favorable AFR for the

current month or either of the prior two months.

THE ABILITY TO USE THE SEMI-ANNUAL RATE

A common misconception among practitioners is that the published rate for annual compounding should apply when interest is payable annually.

Somewhat illogically, Section 7872(f)(2)(A) states that in the case of any term loan the applicable Federal Rate will be the effective rate "compounded semiannually." Further, Section 7872(f)(2)(B) indicates that the demand loan rate will be the short-term applicable Federal Rate "compounded semiannually."

As such, the rate which is compounded semiannually appears to be universally applicable to loans whose interest rates are determined under Section 7872.

This illogical conclusion causes the authors to wonder why Congress shaped the law in this manner. The authors are unaware of any circumstance where the annual rate would be used for a demand or term loan.

ESTATE TAX INCLUSION RISK

Although the AFR is a below market interest rate, there is a concern that somehow this exposes the assets in the trust that is the maker of the note (intra-family loan) to inclusion in the lender's gross estate under Section 2036(a).

The authors believe that the same analysis that concludes that the use of the Section 1274(d) AFR must be used for valuing a term loan under Section 7872 for gift tax purposes supports the view that the use of the AFR, even if it *is* a below market interest rate, should *not* create any powers that would cause inclusion in the lender's gross estate.

It is a well-accepted transfer tax principle that since the gift taxes and the estate taxes are in pari materia, that gift tax principles must be used for the *estate* tax as well.[16] At worst, we think that making a loan at below market rates is a gift, and there is no indication that the making of a gift is a retained interest under Section 2036(a).

The *real* issue under Section 2036(a) is whether there was an *understanding* that the assets in the trust would be accessible to the lender. This is a factual determination, and as long as the parties respect the debtor/creditor relationship, we are comfortable that Section 2036(a) should not be a concern.

COMMENT:

As the foregoing analysis demonstrates, the selection of the correct interest rate, whether from inception or in the context of the re-negotiation of an existing note, is fraught with issues. This is clearly an area where advisors must bring their "A" game to the table before taking the plunge.

TECHNICAL EDITOR'S COMMENT:

The authors make some excellent points about a very timely and important

topic.

The most provocative part boils down to a fundamental question:

Does *all* of Code § 1274(d) apply for *transfer tax* purposes, or were the drafters of Code § 7872(f)(2)(A) just sloppy when they did not refer to Code § 1274(d)(1) instead of Code § 1274(d)?

Why did the *other* commentators say that Code § 1274 did *not* apply, and then apparently *themselves* turn around and apply Code § 1274?

Perhaps these other commentators struggled to give meaning to this language from Frazee:

The language of the sections as well as the legislative history indicates that section 7872 applies for gift tax valuation purposes, while section 1274 does not. Accordingly, we hold that section 1274 has no relevance for gift tax valuation.

The authors probably have the better argument that

"as of the day on which the loan was made"
includes the lowest 3-month rate referred to under Section 1274(d)(2).

I would certainly use that argument when called upon to *defend* a transaction - planned by someone else - on that basis.

However, the *Frazee* court seemed to view Code § 7872(f)(2)(A) as simply referring to the way the IRS determines the monthly interest rates (and *not* the lowest 3-month rate), which rates are then used when applying the basic framework of Code § 7872.

When planning transactions I will continue to rely on the AFR for the month of the sale, rather than risking a possible argument over this issue. I will make this judgment call for planning purposes - even though the authors may be right as a matter of law.

The authors' footnote 13 is a terrific summary of commentary on refinancing notes. For a straight loan for cash, refinancing once should be relatively safe. However, if one *repeatedly* refinances, the IRS might argue that the lender never really *intended* to charge the stated rate of interest but rather intended to charge a floating interest rate. For a loan financing a sale, technically refinancing might have no gift tax consequences. But a judge who is convinced that a taxpayer is playing games might try to find a reason to hold in favor of the IRS.

Would a third-party lender on a transaction structured the way such sales are typically put together really be willing to refinance to a lower rate, especially in today's lending environment? Again, this is not a matter of the refinancing being technically incorrect; rather, the question is provoking an IRS agent or a judge in a transaction that is likely to be heavily scrutinized.

As the authors suggest, we have lots of great opportunities in today's low-interest environment.

But we should proceed *carefully*. How risk-taking or risk-averse you will be is a matter for you to decide.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Alan Gassman

Jerry Hesch

Technical Editor – Steve Gorin

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CITES:

Frazee v. Commissioner , 98 T.C. 554 (1992); *Merrill v. Fahs*, 324 U.S. 308 (1945); 26 U.S.C. § 1274; 26 U.S.C. § 7278; 26 U.S.C. § 2036; 26 U.S.C. § 108; 26 C.F.R. § 1.1001-3; 26 C.F.R. §1.707-4(a)(3)(ii); 26 C.F.R. §1.7520; 26 C.F.R. §20.7520; 26 C.F.R. §25.7520; Deficit Reduction Act of 1984, Pub. L. 98-369, Sec. 172(a), 98 Stat. 494, 699; **Diana Zeydel** "Planning in a Low Interest Rate Environment: How Do Interest Rates Affect the Calculations in Commonly Used Estate Planning Strategies," 33 Tax Management Estates, Gifts & Trust Journal 223 (2008); **J Blattmachr and Madden**, "How Low Can You Go?" 109 Journal of Taxation 22 (2008); **Philip J. Hayes**, "Adventures in Forgiveness and Forgetfulness: Intra-Family Loans for Beginners," Vol. 13, Issue 2 California Trusts and Estates Quarterly 5 (2007); **Howard Zaritsky, Steve R. Akers, and John B. O'Grady**, "Useful Uses of Grantor Trusts in Modern Estate Planning: Taking Advantage of a Popular Non-Entity" 43rd Univ. of Miami Heckerling Institute (2009).

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[1]
[ ] The Authors would like to thank **Christopher J. Denicolo, J.D., LL.M.**, an associate at the firm of **Gassman, Bates & Associates, P.A**, for his help in drafting this article.

[2]
[ ] AFR is the minimum rate that can be used without causing the OID rules to treat a portion of the stated principal as disguised interest. There is no prohibition on using a reasonable interest rate higher than the AFR. In fact, in determining whether a distribution to a partner is an excessive return that constitutes a disguised sale of part or all of the property that partner had contributed., Reg. § 1.707-4(a)(3)(ii) provides a safe harbor maximum interest rate of 150% of the long-term AFR then in effect.

[3]
[ ] See § 1274(d)(2). GRATs have no such choice as § 2702 mandates that

the § 7520 rate for the month the GRAT is settled must be used.

[4]
[ ] Section 1274(d)(2) states that "in the case of any sale or exchange, the Applicable Federal Rate shall be the lowest 3-month rate." This means the lowest of the rate in effect for the calendar month of the sale or exchange, or the rates in effect for the prior two calendar months.

[5]
[ ] Most freeze transactions are premised upon the ability of junior family members, or trusts for junior family members, to borrow at a low rate of interest and invest the borrowed funds at a rate of return greater than the cost of the borrowing. Using financial arbitrage for wealth shifting from Senior to Junior is especially beneficial because the AFR is a below market interest rate. Since the AFR is based on the prior month's T-Bill rates, it will always be less than market rates even in periods of high market rates. See **Diana Zeydel** "Planning in a Low Interest Rate Environment: How Do Interest Rates Affect the Calculations in Commonly Used Estate Planning Strategies," 33 Tax Management Estates, Gifts & Trust Journal 223 (2008), which concludes that for many freeze techniques, the interest rate spread is always advantageous even when the AFR is historically high.

[6]
[ ] As stated above, the AFR is a below market interest rate regardless of whether market rates are high or low.

[7]
[ ] The OID rules are designed to determine the amount and the timing of the interest income and interest expense inherent in obligations that are treated as "debt obligations" for Federal income tax purposes.

[8]
[ ] For a brief analysis of this viewpoint, see **Howard Zaritsky, Steve R. Akers,** and **John B. O'Grady**, "Useful Uses of Grantor Trusts in Modern Estate Planning: Taking Advantage of a Popular Non-Entity," Special Session Materials I-C at pages 73-74, 43rd Univ. of Miami Heckerling Institute on Estate Planning (2009).

[9]
[ ] In 1984 Congress enacted Section 7872, which prescribes the income and gift tax treatment for certain below-market interest rate loans. Deficit Reduction Act of 1984, Pub. L. 98-369, Sec. 172(a), 98 Stat. 494, 699. Under Section 7872, a below-market loan is characterized as an arm's-length transaction in which the lender is treated as transferring to the borrower on the date the loan is made the excess of the issue price of the loan over the present value of all the principal and interest payments due under the loan. Such transfer by the lender to the borrower is deemed a gift. In effect, Section 7872 requires that all loans among related parties or even unrelated parties bear an interest rate based on the then-current Applicable Federal Rate.

[10]
[ ] Not surprisingly, there are other situations where there has been confusion whether the definitions found in Subchapter C of Chapter 80 are limited to only the income tax. For example, the valuation rules mandated under section 7520 apply to the income taxes, the gift taxes and the estate taxes. See Reg. §§ 1.7520, 20.7520 and 25.7520. In addition, a disregarded entity under the check the box regulations may be disregarded for the transfer taxes as well as the income taxes.

[11]
[ ] The legislative history of Section 7872 states that its tests for adequate stated interest and its applications leading to the imputation of interest create interest for income tax purposes and for gift tax purposes. Joint Committee,

General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 524, 528-529 (Dec 31, 1984).

[12]
[ ] 98 T.C. 554 (1992). See also P.L.R.s 9535026 and 9408018 following the Tax Court's analysis in *Frazee*.

[13]
[ ] See **J Blattmachr and Madden**, "How Low Can You Go?" 109 Journal of Taxation 22 (2008), discussing the tax treatment when this occurs. For a contrary view see Philip J. Hayes, "Adventures in Forgiveness and Forgetfulness: Intra-Family Loans for Beginners," Vol. 13, Issue 2 California Trusts and Estates Quarterly 5 (2007). The complete analysis provided under the article by Philip J. Hayes is as follows:

> One factor indicating that a loan lacks bona fides is the exchange, during periods of falling interest rates, of a note for a new note with the same principal amount but bearing a lower interest rate. Some practitioners are unconcerned with refinancing an intra-family loan to a lower rate if the loan allows prepayment (almost all do, or, if silent, state law permits). More cautious advisors recommend avoiding this practice (see, eg. Benjamin Feder, "The Promissory Note Problem," 142 Trusts and Estates 10 (January 2003)), however, based on the plain economic reality that a true lender would not trade one asset for another less valuable. To avoid the IRS argument that the loan is actually a gift, these advisors recommend renegotiating the terms of the note to compensate the lender for the lower interest rate; perhaps by paying down the principal amount, shortening the maturity date, or adding more attractive collateral. The IRS has provided no direct authority on this issue. The Proposed Regulations include a section entitled "Treatment of Renegotiations," (Prop. Treas. Regs. C 1.7872-11(e)) but merely reserves the subject for later guidance, which has not been forthcoming.

[14]
[ ] For example, if there is a reduction in interest rates, there is no need to consider if that modification creates an income tax realization event under Reg. § 1.1001-3 (the *Cottage Savings* regulations).

[15]
[ ] See Section 108(i)(4). The deferral provisions of Section108(i) apply to a “reacquisition” of a debt instrument issued by a C Corporation or any other person in connection with a trade or business. The term "reacquisition" includes such events as an acquisition of a debt instrument for cash, the exchange of the debt instrument for another debt instrument (including an exchange resulting from the modification of a debt instrument), the exchange of a debt instrument for corporate stock or a partnership interest, and the contribution of a debt instrument to capital. A “reacquisition” also includes the complete forgiveness of indebtedness by the holder of the debt instrument.

[16]
[ ] *Merrill v. Fahs,* 324 U.S. 308 (1945).

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