Estate Planning Techniques in a Higher Interest Rate Environment

B. Wade Bowen
wbowen@mwlaw.com
(870) 938.6254

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One can hardly miss the high levels of inflation currently affecting our economy. Even for those who do not pay close attention to the news, where inflation could hardly be more covered, the price of nearly everything for consumers has skyrocketed as we have emerged from the COVID pandemic.

To try to reign in inflation, the Fed has hiked its federal funds benchmark rate significantly this year. In March 2022, the Fed raised its rate by 25 basis points, the first raise since 2018. That raise was followed by 75 basis point increases in June 2022 and July 2022, and another 75 basis point increase just in September. Further, based upon the Fed's projections, it appears additional hikes are forthcoming.

While these increases mean many kinds of consumer financing, from mortgages to car loans to credit card debt, will become more expensive, these increases also impact the effectiveness of certain estate planning techniques. While some techniques become less effective in a higher rate environment, others become more so.

The short-, mid- and long-term applicable federal rates (or AFRs) and the § 7520 rate are published each month by the IRS. Because all of these rates are based upon the yields of marketable debts such as U.S. Treasury bills, the Fed's adjustments to the benchmark rate affects the AFRs and the § 7520 rate. AFRs are the minimum interest rate the IRS requires for private loans or loans between family members; the § 7520 rate, which is 120% of the mid-term AFR, is used to calculate annual payments for certain estate planning techniques.

Several techniques typically employed in a low-rate environment use loans and/or sales to related family members or trusts to leverage the low interest rate applicable to the transaction to transfer wealth with little or no gift tax. These techniques have been employed frequently over the last decade while interest rates have remained historically low.

For instance, if family member were to loan cash to another family member in exchange for a promissory note, the short-, mid- or long-term AFR would apply to the loan. The loan could be structured as interest-only with a balloon payment due at maturity. So long as the asset in which the cash was invested appreciated at a rate greater than the interest rate paid on the loan, the excess value would pass to the borrower free of gift tax. A common technique similar to an intra-family loan involves an installment sale to an Intentionally Defective Grantor Trust, or IDGT, in which a grantor/lender creates a trust/borrower and sells an asset to the trust in exchange for a promissory note, but structures the trust to be to a grantor trust for income purposes. The sale will be ignored for income tax purposes, and no income will be recognized by the grantor when the grantor receives interest payments on the promissory note. The trust property, as well as subsequent appreciation, which accrues to the trust beneficiaries free of gift tax, should be removed from the grantor's estate for federal estate tax purposes. Further, because the trust is a grantor trust, the grantor is treated as the owner of the assets for income tax purposes, and the assets are not depleted by income tax liability. Benefit can also be realized in using Grantor Retained Annuity Trusts (GRATs) and Charitable Lead Annuity Trusts (CLTs or CLATs), which both use the § 7520 rate, when the assets within the trusts appreciate faster than the interest rate applicable to the transaction.

Two particular techniques work well in higher interest rates; the higher the rate, the more effective the technique. The first is a Charitable Remainder Annuity Trust, or CRT or CRAT. It is the reverse of a CLAT. With a CRAT, a grantor creates a trust and contributes assets to it in exchange for payment of an annuity over a term of years. After the annuity term runs, the charitable beneficiary selected by the grantor receives the remainder. The value of the remainder is calculated using the § 7520 rate at the time the grantor funds the trust, which results in a charitable deduction for income tax purposes. By statute, the value of the remainder must meet a minimum threshold. Therefore, the higher the § 7520 rate, the higher the value of the charitable interest, meaning the more likely to pass the statutory threshold. Additionally, CRATs must make a minimum annual payment to the grantor. Higher rates help younger grantors minimum payments.

A Qualified Personal Residence Trust, or QPRT, is also more effective in a higher rate in environment. A QPRT is a trust to which a grantor's personal residence is transferred for the purpose of ultimately transferring the resident to the trust beneficiaries. The QPRT lasts for a term of years in which the grantor may continue to reside in the house. When the term concludes, the residence passes to the trust's beneficiaries, who may rent the home to the grantor at fair market value. The value of the remainder interest in the home is a taxable gift at the time the home is transferred to the trust. The value is calculated using the § 7520 rate. In higher rate environments, the value of the grantor's right to use the residence increases, making the value of the taxable gift lower.

Interest rates are undoubtedly cyclical, and the effectiveness of the techniques discussed here increase and decrease along with rates. It is therefore wise to be mindful of the various techniques that are available to take advantage of changing rates.