The impact of rising interest rates on estate planning strategies.

By Rebecca J. Solomon, JD, LL.M.

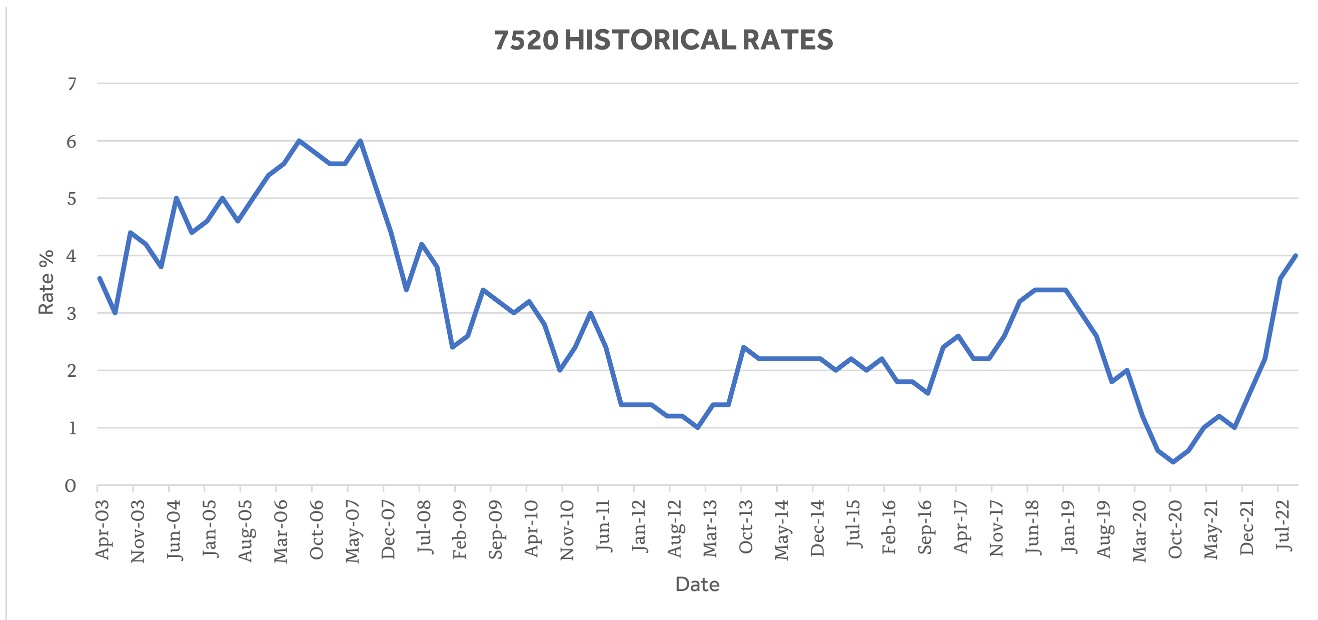
On September 21, the Federal Reserve raised its benchmark Federal Funds Rate for the fifth time in 2022, for a cumulative total of 300 basis points since March 2022. The Fed made these aggressive rate increases to fight inflation, which stood at 8.3% year-over-year at the time of its latest rate hike. These increases in the Federal Funds Rate cascade to all corners of finance, from credit card rates, auto financing, mortgages, and other rate-sensitive loans, to the fixed income (bond) markets.

Rising interest rates also impact the interest rates used in many estate planning strategies. First, rate increases are directly reflected in the Applicable Federal Rates (AFRs), which are published monthly by the IRS for federal income tax purposes. For estate planning purposes, the monthly AFRs establish the minimum rates for loans used in various planning strategies.

Changes in the AFRs also affect the "7520 rate," which is defined as 120% of the mid-term AFR rate (compounded annually) for that month. The 7520 rate is used to determine present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest. Thus, the 7520 rate has arguably the largest impact on estate planning strategies. The 7520 rate stood at 4.00% in October 2022. The chart on the page below shows the 7520 rates over the last 20 years.

Estate planning strategies negatively impacted by higher rates

Intra-family loans will be less effective in a higher interest rate environment. The AFR rate determines the minimum amount of interest that must be charged on such loans. This technique includes loans to family members to finance major purchases, to start a business, or meet other financial obligations. These loans can also be used as an asset shifting strategy, in which a senior family member loans a sum



to a junior family member, and the funds are used to invest in assets expected to have a return greater than the interest rate on the loan. When the loan is paid back, the junior family member keeps the difference between the return on the investment and the interest paid on the loan, effectively shifting the economic benefit from the senior family member without any gift tax consequence. Unfortunately, the higher the interest rate, the fewer assets that can be shifted to the junior family member. It also increases the risk that the investment will not outperform the rate on the loan, leaving the junior family member with a loss. Note that the lending family member will have to recognize the interest income on his/her tax return.

Installment sales to an intentionally defective grantor trust (IDGT) will also be adversely affected. This strategy involves an individual (the grantor) who "sells" property to a grantor trust created by him/her in exchange for a promissory note. The goal is that the property sold to the trust will have a total return greater than the interest rate on the loan, so that the net return after interest is retained in the IDGT, with no gift or estate tax consequence. Since the sale is to a grantor trust, the lender does not recognize any interest income for tax purposes, and the assets can grow income tax-free in the IDGT while the grantor is alive. However, as with intra-family loans, a higher interest rate will result in fewer net assets retained by the IDGT, and there is a similar risk that the total return on the asset sold will not outperform the rate on the loan. The hurdle to clear in order for this strategy to make economic sense gets higher as interest rates rise.

Similar to the sale to an IDGT strategy, the use of a grantor retained annuity trust (GRAT) will also be negatively affected by higher rates. The GRAT strategy involves a "split-interest" trust, in which the trust's grantor transfers assets to the GRAT, and the GRAT pays back to the grantor a fixed annuity for a term of years. After that term is up, the remainder interest then stays in trust or is paid out to the remainder beneficiaries. Since the IRS's 7520 rate determines the value of the annuity retained by the grantor, the goal is that the total return on the assets in the GRAT outperforms the 7520 rate, so after the annuity term the assets go to the remainder beneficiaries without gift or estate tax consequences. In this case, the 7520 rate is the hurdle that must be cleared, and a higher 7520 rate results in a larger annuity payment back to the grantor and fewer assets for the remainder beneficiary.

A charitable lead annuity trust (CLAT) is another type of split-interest trust, except the annuity payments for a term of years are made to a charity and the grantor is entitled to a charitable deduction for the amounts passing to charity. Only the assets calculated to remain at the end of the term are subject to gift tax. As with the GRAT strategy, a higher 7520 rate increases the charitable annuity and decreases the remainder for the grantor's family (assuming all other factors remain the same).

Estate planning strategies that benefit from higher interest rates

A charitable remainder annuity trust (CRAT) is essentially the reverse of a CLAT—the non-charitable beneficiary receives an annuity for a term of years or for life (or two people

can have a joint and survivor annuity for life), and the remainder goes to a named charity. In this case, higher 7520 rates will result in higher annuity payments to the family, assuming all other factors remain the same. The only caveat is that Treasury regulations require a minimum of 10% of the initial trust value must go to the charity in order for a CRAT to be valid. The IRS has also ruled that a CRAT is not valid if there is a greater than 5% chance that the trust fund will be exhausted before the trust ends. So, there is an upper limit as to how much a CRAT can pay out to the non-charitable beneficiaries. Nevertheless, higher 7520 rates make CRATs more attractive as an estate planning strategy.

The other strategy that benefits from higher 7520 rates is the qualified personal residence trust (QPRT), a split-interest trust used to transfer a residence or vacation home to children or other family members at a discounted value for gift tax purposes. The grantor(s) transfer the home to the trust and retain the right to use/occupy the home for a period of years. At the end of the term, the home is retained in trust or transferred to the children or others. As above, higher 7520 rates increase the value of the retained interest and decrease the value of the remainder interest—the amount subject to gift tax. The relationship between the 7520 rate and the amount of the taxable gift is illustrated in the table below, showing the taxable gift for the same QPRT terms over the last five years.

Qualified Personal Residence Trust 20-Year Term $1,000,000 FMV Real Property		
Date	**7520 Rate**	**Taxable Gift**
Oct 2022	4.0	$364,230
Oct 2021	1.0	$654,050
Oct 2020	0.4	$736,820
Oct 2019	1.8	$558,580
Oct 2018	3.4	$408,910

Final Thoughts

While interest rates impact these estate planning strategies in substantial ways, one should be careful not to let the "interest tail" wag the dog. While interest rates are relatively high now, they still remain within reasonable levels compared to historical patterns. Even if the hurdle to break even on an estate planning strategy is now around 4%, it will still make economic sense if the underlying asset is expected to have a total return substantially greater than 4%. Waiting for rates to decrease also may not be wise. Even if a strategy does not yield as much benefit as before, any amount that can be transferred out of one's taxable estate now is better than none.

In the meantime, work with your professional advisors to take advantage of the opportunities that higher rates bring to estate planning by considering the benefits of a CRAT or a QPRT.

Rebecca Solomon, JD, LL.M., joined The Nautilus Group in 2020 as a member of the case development team, bringing more than 25 years of experience in the areas of estate planning, estate and gift tax compliance, business planning, and philanthropic services in both private law practice and public accounting. She has been a frequent speaker at national conferences on estates and trusts, and she is a past instructor in the Certified Financial Planner™ education programs at two universities. Rebecca earned her B.A. in political science from the University of Michigan, her J.D. from Michigan State University College of Law, and her LL.M. in tax from Wayne State University Law School.

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