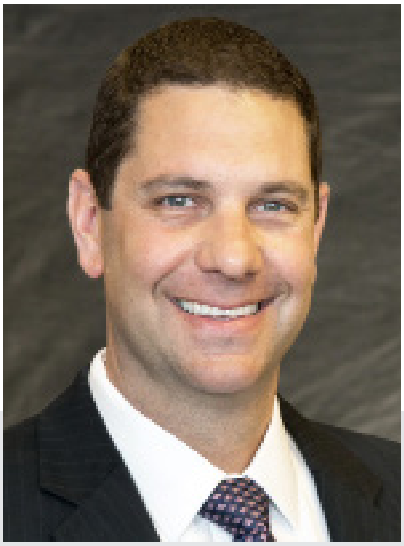
# High or low

## Interest rates and their impact on estate planning strategies

**INTERVIEWED BY ADAM BURROUGHS**



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Evidence of rising inflation has caused the Federal Reserve to accelerate the timeframe on when it will next raise interest rates. This will have an effect on borrowing costs, stocks, bonds, commodities, currencies, as well as estate planning strategies.

*Smart Business* spoke with William J. Stein, an attorney at Semanoff Ormsby Greenberg & Torchia, LLC, about how interest rates impact estate planning and what to consider in both high and low interest rate environments.

### HOW DO INTEREST RATES AFFECT ESTATE PLANNING?

Interest rates are fueled in part by increases in the federal funds rate, which is the interest rate that banks charge each other for short-term loans. Increases in the federal funds rate typically have a chain-reaction effect on long-term interest rates, including the two primary interest rates used in many estate planning strategies — the Section 7520 rate and the Applicable Federal Rate (AFR).

Certain estate planning strategies depend on investments returning more than the 7520 Rate to be successful, so they tend to be most effective when the 7520 Rate is low.

The AFR is the minimum interest rate that must be charged on loans to avoid triggering imputed income or gift taxes. Certain strategies that use the AFR to determine the present value of payments are more effective when interest rates are higher because a higher AFR will lead to a lower present value and, therefore, a lower tax cost for a particular strategy.

### WHAT STRATEGIES ARE AVAILABLE IN HIGH- AND LOW-RATE ENVIRONMENTS?

Efficient higher-rate environment strategies include the Qualified Personal Residence Trust (QPRT) and the Charitable Remainder Annuity Trust (CRAT).

In a QPRT, a homeowner places a residence in trust but retains the right to live in the residence rent-free for a designated period, then the residence passes to the trust beneficiaries. The initial transfer to the QPRT is a taxable gift of the remainder interest, calculated using the 7520 Rate. The higher the rate, the higher the value of the grantor's right to use the residence during the designated period, and the lower the future remainder interest. So as the 7520 Rate increases, the taxable gift decreases, making the QPRT a more attractive strategy at higher interest rates. With a CRAT, the grantor places an asset in a charitable trust. The trust pays an annuity to the grantor for a term of years. At the end of the annuity term, the remainder is given to a designated charity. The value of the remainder, calculated using the 7520 Rate at the time the trust is created, gives the grantor an income tax charitable deduction. The higher the 7520 Rate, the higher the value of the charitable interest.

Planning when interest rates are low often involves leveraging lending strategies to transfer wealth with little or no gift tax. Efficient wealth transfer strategies in a low interest rate environment include intra-family loans, the Charitable Lead Annuity Trust (CLAT) and the Grantor Retained Annuity Trust (GRAT). The simplest method is to make a cash loan structured as an interest-only loan with a balloon payment on maturity. If the assets purchased with the loan proceeds appreciate more than the interest rate paid on the loan (the AFR), the excess passes to the borrower free of gift tax. With a GRAT, the grantor places assets into an irrevocable trust but receives payments over the term of the GRAT equal to the original value of the assets plus any appreciation up to the 7520 Rate. Any appreciation in excess of the 7520 Rate passes to the trust beneficiaries.

A CLAT is similar to a GRAT, in that asset appreciation over the 7520 Rate passes to the trust beneficiaries gift tax free. However, the annuity payments during the lead term are paid to a charity instead of the grantor. Depending on how the CLAT is structured, the grantor may receive a charitable income tax deduction when the trust is funded.

### WHAT ELSE SHOULD THOSE WHO ARE ESTATE PLANNING THIS YEAR CONSIDER?

For those considering implementing or updating estate plans this year, additional considerations include utilization of the temporarily increased transfer tax exemptions, the potential for increased transfer tax rates and higher income tax rates given the current political climate, and the possible repeal of the step-up in basis at death. ●