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# Defying Gravity: Estate Planning in a High(er) Interest Rate Environment

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Anyone who has ever taken a ride on a roller coaster knows that what goes up must come down. Gravity is the force that keeps us grounded and assures that nothing strays too far from earth. Interest rates, however, are not subject to the laws of gravity, and as inflation continues, interest rates will continue to defy gravity.

Rising interest rates greatly impact estate planning techniques and strategies. Over the past decade, planners have been operating in a historically low-interest rate environment that has served to supercharge many estate planning strategies. With the era of low-interest rates coming to a close, estate planners will need to revert to some old tricks to make use of planning strategies for high-interest rate environments.

Each month, the Internal Revenue Service (IRS) publishes the “applicable federalrate” or “AFR”. The AFR is a key interest rate that is used in many estate planning techniques. This rate is often used in estate planning as the minimum rate necessary to avoid adverse gift or estate tax consequences in a transaction. Fluctuation in the AFR can significantly impact the success of a planning strategy.

## Locking in Low Interest Rate Strategies

It is widely anticipated that interest rates will continue to increase over the next year. It is therefore crucial that individuals should act now before interest rates rise too quickly and too high to warrant many planning techniques.

***Related-Party Loans***

In a low-interest rate environment, related-party loans are an effective planning strategy to transfer appreciation out of an individual’s estate. In this strategy, an older family member will lend money to a younger family member. The younger family member may then invest the funds with the hopes that the growth and appreciation on the funds will exceed the interest rate used for the lending. If the asset appreciates at a rate greater than the interest rate used for the loan, then the excess appreciation over the interest transfers to the younger generation free of any gift and estate tax consequences.

As interest rates rise, the rate of growth in excess of the loan rate decreases. Because related-party loans will become less successful with higher interest rates, it is crucial to lock in lower interest rates on related-party loans before interest rates rise too high.

### *Sales to Intentionally Defective Grantor Trusts*

Sales to intentionally defective grantor trusts (IDGTs) are an effective estate planning technique in low-interest rate environments. A grantor trust is a trust that is treated as the grantor for income tax purposes. All of the income earned in a grantor trust is taxed directly to the grantor as if the grantor owned the assets. In an IDGT, however, the assets in the IDGT, while treated as owned by the grantor for income tax purposes, are not treated as being included in the grantor's estate for gift or estate tax purposes. The trust is "defective" in the sense that it is treated one way for income tax purposes but another way for estate tax purposes.

Transactions between the grantor and the IDGT are not taxable events for federal income tax purposes because such transactions are treated as occurring between the grantor and himself or herself. A common planning strategy that is therefore used is a sale to an IDGT. With this strategy, the grantor may sell a highly appreciating asset to the IDGT and take back a promissory note that pays interest based upon the AFR. The payment of the interest is not a federally income taxable event (but it is taxable for Pennsylvania income tax purposes). So long as the rate of growth and appreciation on the assets in the IDGT exceed the AFR, the excess growth and appreciation will be outside of the grantor's taxable estate.

Similar to related-party loans, taxpayers should lock in their sales to IDGTs to preserve the current interest rates on their promissory notes before rates rise even higher. While sales to IDGTs will continue to be a beneficial planning technique in higher-interest rate environments, their effectiveness will be reduced as interest rates rise.

### *Grantor Retained Annuity Trusts*

Another beneficial strategy to implement before interest rates rise is grantor retained annuity trusts (also known as GRATs). A GRAT is an irrevocable trust in which a grantor transfers property and receives an annuity payment from the trust for a fixed term. At the end of the GRAT term, the grantor's annuity payments end and any property remaining in the trust passes to the remainder beneficiaries free of gift and estate tax. The calculation of the value of the remainder interest being gifted is determined based upon the AFR. The lower the AFR, the smaller the value of the remainder interest and the smaller the gift. The higher the AFR, the larger the value of the remainder interest and the larger the gift. Therefore, GRATs are best utilized in low-interest rate environments where the value of the grantor's gift to the GRAT may be smaller.

Grantors looking to implement GRATs in their estate plans should create GRATs now before interest rates rise. As with related-party loans and sales to IDGTs, the effectiveness of GRATs will decrease as the interest rates begin to reach the growth rate of the assets inside the GRAT.

## Techniques for Higher Interest Rate Environments

While many estate planning techniques are best used in low-interest rate environments, some planning strategies are best used in high-interest rate environments.

### *Qualified Personal Residence Trusts*

A qualified personal residence trust (QPRT) is an irrevocable trust that holds an individual's primary residence during a set term, and upon the completion of the term, the primary residence passes to the remainder beneficiaries. By gifting the personal residence to the QPRT and retaining an interest in the residence for a set term, the grantor is gifting the value of the remainder interest that passes at the conclusion of the term of the QPRT to the remainder beneficiaries.

The calculation of the value of the remainder interest in based upon the AFR. As interest rates rise, the value of the remainder interest shrinks. Thus, the higher the interest rate, the lower the value of the remainder interest and the lower the gift. QPRTs are most effective in high interest rate environments when a residence is likely to appreciate in value.

Grantors should be aware that when a residence is gifted to a QPRT, the residence will have a carryover basis. Upon the grantor's death, the residence will not get a step-up in basis. As a result, QPRTs are ideal for clients with taxable estates where the loss of a step-up in basis is outweighed by the removal of the residence from the grantor's taxable estate. If the grantor will not be subject to estate tax, the step-up in basis may be more beneficial to the grantor's heirs than the removal of the property from the grantor's estate for estate tax purposes.

***Charitable Remainder Trusts***

A charitable remainder trust (CRT) is a split interest trust which initially benefits a non-charitable beneficiary (usually the grantor or the grantor's spouse) during the term of the CRT and benefits a charity at the conclusion of the term of the CRT. A CRT is similar to a GRAT, except the remainder beneficiary in a CRT is a charity. During the term of the CRT, the noncharitable beneficiary receives either regular annuity or unitrust payments and the charitable beneficiary receives the remainder interest. The grantor's gift to a CRT is therefore equal to the value of the remainder interest in the CRT. The present value of the remainder interest is calculated using the AFR in effect at the time the grantor makes a contribution to the CRT and will provide the grantor with a charitable deduction for both income and gift tax purposes. At all times, the remainder interest must equal at least 10% of the fair market value of the assets contributed to the trust.

While GRATs work best in low interest rate environments, CRTs work best in high interest rate environments. In a high interest rate environment, the remainder interest will be larger in both GRATs and CRTs. Since the remainder beneficiary in a GRAT is a noncharitable beneficiary, GRATs are most effective when the remainder interest is smaller. In a CRT, however, the charitable deduction will be maximized when the remainder interest is larger.

Hopefully, interest rates will eventually return to the historically low levels of the past decade. In the meantime, individuals should lock in their low interest rate planning strategies before interest rates rise too high. Then, they should shift their planning to higher interest rate strategies such as the use of QPRTs and CRTs.

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