

Key Interest Rates in Advanced Estate Tax Planning

Chairman of the Federal Reserve Jerome Powell has been an intensely watched figure since March, 2022 when he announced the first of a string of recent interest rate hikesⁱ. Among Chairman Powell's stated purposes for these rate hikes are "...to promote maximum employment and stable prices for the American peopleⁱⁱ."

As an unintended bonus, the Fed's rate hikes have also made certain estate tax and income tax planning techniques more effective than in lower interest rate environments.

The "Applicable Federal Rate" (AFR) and the "7520 Rate" are probably the two most referenced interest rates in the world of advanced estate tax planning.

- **Applicable Federal Rate:** AFR is calculated pursuant to the Internal Revenue Codeⁱⁱⁱ (IRC) and comes in three varieties:

- (1) short-term for debt instruments with maturity not more than 3 years;
 - (2) mid-term for debt instruments with maturity more than 3 years but not more than 9 years;
- and
- (3) long-term for debt instruments greater than 9 years.

The IRS publishes AFR monthly by Revenue Ruling^{iv}. The rates float each month and are generally calculated based on average debt yields of US debt obligations of similar term.

In estate planning, the AFR is used to avoid the below-market interest rate rules of the Internal Revenue Code^v. If the appropriate measure of AFR is not used in related party loans, then the loan could have unintended income tax and gift tax consequences.

The AFR is often used in the estate tax planning context of intra-family loans, including promissory notes issued in connection with sales of assets to intentionally defective grantor trusts (IDGTs).

- **7520 Rate:** The 7520 Rate is calculated as 120% of the mid-term AFR^{vi}. The 7520 Rate is generally used for estate and gift tax purposes to calculate the values of annuities, life estates, and remainder interests^{vii}. For example, the 7520 Rate is used to calculate the retained annuity interest under a Grantor Retained Annuity Trust (GRAT)^{viii}. The remainder interest in a Charitable Remainder Trust (CRT) is also calculated using the 7520 Rate^{ix}.

Advanced Estate Tax Strategies that Benefit from Higher Interest Rates

Certain advanced estate tax planning strategies are generally viewed as more efficient in a lower interest rate environment, while others shine brighter with higher rates.

- **Intra-Family Loans**: Intra-family loans are loans between family members having a gift rather than commercial purpose. Most often, the lender is mom, dad, or other senior generation individual, and the borrower is a member of a younger generation.

Intra-family loans can help younger generation borrowers reduce borrowing costs and complexity. For example, an intra-family loan to buy a residence would not go through the same voluminous mortgage underwriting as a commercial mortgage. This could be very important for a younger family member without established credit and income history. Intra-family loans also allow money to stay within the family unit since younger generation borrower is repaying senior generation lender. Finally, intra-family loans have the effect of “freezing” the portion of the estate of the lender by virtue of capping growth of the borrowed funds at the AFR.

The benchmark for intra-family loans is AFR. While AFR has certainly increased with the Fed’s recent rate increases, the AFR may still be less than prevailing commercial interest rates.

Consider the advantage intra-family lending at AFR may present for August, 2023:

- The long-term AFR is 3.96%^x.
- The Wall Street Journal Prime Rate is 8.5%^{xi}.
- The national average APR for a 30-year fixed rate mortgage is 7.28%^{xii}

Intra-Family Loan Considerations

Consider raising the prospect of making intra-family loans to clients who desire to help younger generation family members but not with a direct gift. Many clients prefer to loan money for a child’s first home purchase so that the child ultimately earns home ownership. Loans may also be quite useful for clients who wish to assist a child financially but do not have further annual or lifetime gifting capacity (or do not wish to use that capacity for this purpose).

- **Qualified Personal Residence Trust (QPRT)**: A QPRT is a special kind of “retained interest” trust that is specifically allowed under the Internal Revenue Code and Regulations. It is used to transfer a taxpayer’s “residence” to her intended beneficiaries at a lower gift tax cost than a direct gift of the residence.

The QPRT works mechanically like this^{xiii}:

1. The QPRT grantor (person creating the QPRT) has an attorney draft the trust instrument, selects the QPRT Term, and deeds his or her residence to the QPRT creating a taxable gift.

2. The QPRT Term is the “retained interest” held by the QPRT grantor. This is the period of time set forth within the trust during which the QPRT grantor is given the sole and exclusive use and enjoyment of the residence.
3. During the QPRT Term, the grantor remains responsible for paying the everyday expenses of the property, like utilities, property taxes, and repairs (any capital improvements paid by the grantor would be treated as further gifts to the ultimate QPRT beneficiaries and should generally be avoided).
4. If the grantor outlives the QPRT Term, then at the end of that term the ownership of the residence is further transferred to the grantor’s named beneficiaries set forth in the trust (or held for them in further trust). If desired by the grantor and agreed by the beneficiaries, the grantor can rent the property from the beneficiaries at market rent and continue to utilize the property. Rent paid would represent even another wealth transfer opportunity for the grantor.
5. If the grantor dies prior to the end of the QPRT Term, the residence held by the QPRT is included at fair market value in the estate of the grantor, but the grantor receives a credit for the gift tax exemption used when the QPRT gift was first made – so the QPRT grantor is technically no worse off for having attempted the QPRT.

So why does a QPRT have an estate tax benefit and why is that benefit increased in times of increased interest rates?

First, think about the baseline situation where the grantor makes a direct gift (no QPRT) of a residence to his or her intended beneficiaries. That gift would be valued equal to the FMV of the home at the date of gift.

Contrast that with the use of the QPRT, where the QPRT term (retained interest) affords the grantor exclusive use and enjoyment of the property for the period set forth in the QPRT. The Internal Revenue Code assigns a value to that QPRT term and reduces the gift amount by that same value^{xiv}. This results in the taxable gift arising from the QPRT transaction equaling the “remainder” interest in the residence held by the future QPRT beneficiaries.

The value of the QPRT term (retained interest) is based on prescribed IRS tables^{xv} which increase the relevant present value factor, and thus the value of the retained interest, with increasing interest rates, specifically the 7520 Rate described above^{xvi}.

QPRT Client Considerations

Consider raising the prospect of a QPRT to clients with taxable estates who own valuable residences. The QPRT may work best for residences which are expected to continue to experience high appreciation. QPRTs may also be well-suited to reducing the transfer tax burden of keeping long held or sentimental family properties within family lines.

- **Charitable Remainder Trust (CRT):** A CRT is a charitable, irrevocable trust which is often considered in planning for income taxes on the sale of appreciated property and fulfilling the trust grantor’s charitable desires.

The CRT works mechanically like this^{xvii}:

1. The CRT grantor has an attorney draft the CRT, selecting the type of distribution stream, amount of and term during which the CRT will payout to the grantor (or other non-charitable beneficiaries)^{xviii}.
2. The grantor funds the CRT by transferring (typically) highly appreciated assets to it.
3. The CRT liquidates the assets transferred to it but does not pay current income taxes on any gain since the CRT is respected by the IRS as a charitable entity (subject to the Excise Tax on UBTI income which is usually avoided with proper planning)^{xix}. The CRT trustee must keep track of the income generated within the CRT to properly report the taxable income carried out to the non-charitable beneficiary when distributions are made.
4. The CRT proceeds to distribute cash as required by the CRT’s terms to the grantor or other non-charitable beneficiary. These payments carry out taxable income to the non-charitable beneficiary based on the source and character of the income generated by the CRT when it (i) sold the initially contributed assets and/or (ii) invested the proceeds. The rule of thumb here is “worst first” which means that ordinary income comes out first to non-charitable recipients, followed by capital gain income, then non-taxable income, and finally return of principal^{xx}.
5. At the end of the non-charitable beneficiary’s payment term, assets remaining in the CRT are transferred to one or more charitable beneficiaries.

So why do CRTs work better when interest rates generally (and the 7520 rate, specifically) is higher?

First, the Internal Revenue Code provides a current charitable deduction to the CRT grantor at the time of funding the CRT^{xxi}. The deduction is equal to the actuarially calculated present value of the charitable remainder interest based on the CRT payout terms^{xxii}. This is the amount that is “expected” to go to charity at the end of the CRT based on its payout terms and given the relevant 7520 rate. As the 7520 rate increases, the present value of the non-charitable payment stream from the CRT decreases^{xxiii}. This has the result of increasing the charitable remainder interest and thus the initial charitable deduction^{xxiv}.

In addition, a higher 7520 rate can make it easier to meet the technical requirements of the Internal Revenue Code and Regulations in constructing the CRT while at the same time creating an impactful non-charitable payment stream on the front end^{xxv}.

CRT Client Considerations

Consider raising the prospect of a CRT to clients with significantly appreciated and/or highly concentrated asset positions who also have charitable giving desires. The CRT can be flexibly structured while the tax deferral benefit can be utilized to improve overall economic returns. As an additional planning item, the CRT can pay the charitable remainder to a Donor Advised Fund account setup by the CRT grantor. In this way, even after the initial payment stream of the CRT ends, the grantor and/or family members can continue to control the use of charitable dollars into the future.

ⁱ <https://www.cnbc.com/2023/03/16/one-year-after-the-first-rate-hike-the-fed-stands-at-policy-crossroads.html#:~:text=first%20set%20sail-,Exactly%20one%20year%20ago%2C%20on%20March%2016%2C%202022%2C%20the,year%20dismissing%20as%20E%2%80%9Ctransitory.%E2%80%9D>

ⁱⁱ <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20230726.pdf>

ⁱⁱⁱ 26 USC 1274(d)

^{iv} Rev. Rul. 2023-13 (publishing August, 2023 AFR).

^v 26 USC 7872

^{vi} 26 USC 7520

^{vii} <https://resources.evans-legal.com/?p=215#:~:text=Normally%2C%20the%20C%2%A7%2075%20rate,%2C%20life%20estate%2C%20or%20remainder.>

^{viii} <https://www.journalofaccountancy.com/issues/2019/oct/wealth-transfer-grantor-retained-annuity-trusts.html>

^{ix} <https://www.thetaxadviser.com/issues/2014/mar/casestudy-mar2014.html>

^x Rev. Rul. 2023-13

^{xi} <https://www.wsj.com/market-data/bonds/moneyrates> (as of July 27, 2023)

^{xii} <https://www.bankrate.com/mortgages/mortgage-rates/?mortgageType=Purchase&partnerId=br3&pid=br3&pointsChanged=false&purchaseDownPayment=112000&purchaseLoanTerms=30yr%2C5-1arm%2C5-6arm&purchasePoints=All&purchasePrice=560000&purchasePropertyType=SingleFamily&purchasePropertyUse=PrimaryResidence&searchChanged=false&ticaid&userCreditScore=780&userDebtToIncomeRatio=0&userFha=false&userVeteranStatus=NoMilitaryService&zipCode=60656>

^{xiii} <https://www.journalofaccountancy.com/issues/2006/oct/theabcsofqrts.html>

^{xiv} <https://support.leimberg.com/hc/en-us/articles/360054468352-QPRT-GRIT-Qualified-Personal-Residence-Trust#:~:text=The%20value%20of%20that%20gift,years%20the%20trust%20will%20run.>

^{xv} IRS tables also take into account the age of the grantor and the length of the QPRT term in valuing the retained interest.

^{xvi} <https://www.idsupra.com/legalnews/client-alert-leveraging-qrts-in-a-high-9208887/>

^{xvii} <https://www.journalofaccountancy.com/issues/2010/jul/20102678.html>

^{xviii} There are many detailed rules to follow in structuring a CRT which are outside the scope of this article. <https://www.irs.gov/charities-non-profits/charitable-remainder-trusts>

^{xix} <https://www.thetaxadviser.com/issues/2007/jul/teachinganolddognewtricksrtsandubti.html>

^{xx} <https://www.schwabcharitable.org/maximize-your-impact/develop-a-giving-strategy/align-your-giving-vehicles/charitable-remainder-trust>

^{xxi} <https://www.journalofaccountancy.com/issues/2010/jul/20102678.html>

^{xxii} <https://www.naepjournal.org/journal/issue05i.pdf>

^{xxiii} <https://www.naepjournal.org/journal/issue05i.pdf>

^{xxiv} <https://www.thklaw.com/rising-rates-spark-interest-in-charitable-remainder-trusts/>

^{xxv} <https://www.thklaw.com/rising-rates-spark-interest-in-charitable-remainder-trusts/>

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