



Estate Planning in a Changing Interest Rate Environment

As of this writing, the Federal Reserve has raised its benchmark Federal Funds Rate nine times since March 2022, from 0.25% to 4.75%,¹ putting pressure on financial markets and valuations. These rate increases have also had important implications for gift, estate and wealth planning strategies.

In short, the current environment looks very different than it did just 12 months ago. If you haven't reviewed your wealth and estate plan recently, now may be an opportune time to meet with your advisors to consider appropriate strategies for you and your family.

How Rates Impact Estate Planning Strategies

Rising rates create challenges, but they also provide opportunities for effective wealth transfer strategies that we haven't seen for quite some time.

One way the Federal Reserve's actions have an indirect but potentially significant impact on gift and estate planning strategies is through two rates: the Section 7520 rate, commonly referred to as simply the "7520 rate" or the "hurdle rate" and the applicable federal rate, or the "AFR".

The 7520 rate, which has risen from its low of 0.4% in late 2020 to the current rate of 5.0%,² is the rate used to discount the value of annuities, life estates and remainders interests to present value.

The AFR is the minimum interest rate to be charged on private loans or loans between family members. The Section 7520 rate or AFR is set when a gift or estate planning strategy goes into effect, locking in the rate for the duration of the trust, loan, annuity, or other planning technique.

Strategies for Low-Interest Rate Environments

Here are some of the most common low interest rate strategies, and how they are affected by a rising rate environment like the one we have been experiencing for the past 12 months:

Grantor Retained Annuity Trusts (GRAT)

In a grantor retained annuity trust, or GRAT, the grantor places assets into an irrevocable trust for a set period. Typically, the GRAT is structured as a "zeroed-out" GRAT. For the term of the trust, the grantor receives an annuity designed to return the original value of those assets, plus a rate of return determined by the 7520 rate.

The annuity rate is only part of the picture. You also need to consider asset valuations.

At the end of the GRAT term, any assets remaining will pass to the trust beneficiaries, either outright or in trust. Because the grantor has received his/her full contribution plus 7520 earnings, this is considered a zero-value gift so no gift tax is due and no portion of the grantor's lifetime exemption from federal gift and estate tax is used.

When rates are low, the return on assets can more easily exceed the Section 7520 rate, resulting in a larger legacy for beneficiaries. However, when rates rise, the hurdle becomes higher, potentially resulting in a smaller benefit for heirs.

The current interest rate environment is only part of the picture. It is also important to consider asset valuations. Funding a GRAT when asset valuations are depressed creates the opportunity for significant appreciation during the term of the GRAT, potentially resulting in a sizeable transfer to the trust beneficiaries.

Installment Sale to an Intentionally Defective Grantor Trusts (IDGT)

Installment sales to intentionally defective grantor trusts, or IDGTs, are another estate planning tool especially useful in low interest rate environments. With this strategy, the grantor sells assets to a trust and, in exchange, receives a promissory note or notes. While the value of the promissory note will be included in the grantor's estate at death, the value of the trust's assets and, very importantly, all future appreciation, is removed from the grantor's estate.

The trust is called defective because even though the grantor no longer owns the assets and they are not includable in his/her estate, the grantor is responsible for paying taxes on any income generated by the trust. Because the grantor, not the beneficiaries, pays these taxes, the trust assets can grow without being reduced by taxes, resulting in potentially larger benefits to the heirs. The interest paid on any promissory notes is tied to the relevant AFR.

Intrafamily Loans

A fairly easy but potentially powerful way to benefit family members is through an intrafamily loan. In this structure, a loan is made to a family member who can use the proceeds to purchase an appreciating asset, typically from a parent. Often the borrower will make interest-only payments over the lifetime of the loan with a balloon payment due on maturity. If the assets appreciate more than the interest rate on the loan, the incremental value passes to the borrower free of gift tax.

The IRS sets a minimum rate for intrafamily loans tied to the appropriate AFR depending on the maturity of the loan at the time the transaction is completed. The rate remains unchanged during the term of the loan.

Strategies for High or Rising Interest Rate Environments

A higher interest rate environment may make some strategies less valuable, but it also presents an opportunity to revisit planning techniques that have not been widely used in recent years.

Qualified Personal Residence Trusts (QPRT)

A Qualified Personal Residence Trust (QPRT) is a trust established to transfer a personal residence to the trust's beneficiaries, usually children, with reduced gift tax consequences.

A QPRT is established for a term of years, during which the grantor continues to use the home as his or her own. Upon reaching the end of the trust's term, the residence passes to the beneficiaries. If the grantor would like to remain in the home, he or she may choose to rent it at fair market value from the beneficiaries.

For gift tax purposes, the gift value is calculated as the appraised value of the property at the time of transfer, reduced by the value the grantor derives from living in the home, which is calculated using the Section 7520 rate, the grantor's age, the value of the property and the term of the QPRT. The higher the 7520 rate, the greater the value of the grantor's right to use the residence during the trust term and the lower the taxable gift to beneficiaries making the QPRT an attractive strategy in higher interest rate environments.

The current higher rate environment may make some strategies less valuable, but there are opportunities to benefit from estate planning vehicles that take advantage of rising rates.

Charitable Remainder Trusts (CRT)

In a charitable remainder trust, or CRT, the grantor places assets, typically appreciated securities, in an irrevocable trust. The grantor, and/or another non-charitable beneficiary, receives an annuity from the trust for a term of years. At the end of the term, the charity receives the remaining balance.

Charitable remainder trusts come in two basic forms:

- Charitable remainder annuity trusts (CRATs) which distribute a fixed percentage of the trust's original value every year, and additional contributions are not allowed.
- Charitable remainder unitrusts (CRUTs), which distribute a fixed percentage of the current value of trust assets annually, and additional contributions can be made.

The grantor is entitled to a tax deduction equal to the value of the remainder interest calculated using the 7520 rate in effect when the trust is established. To receive IRS approval, the projected value of the remainder interest to be left to charity must be at least 10% of the trust's original value. Because the remainder is calculated using the Section 7520 rate at the time the trust is created, the higher the rate, the more likely the CRT is to meet the 10% threshold and to qualify for favorable tax treatment.

A New Environment Creates New Estate Planning Strategies

Rising interest rates, reduced valuations and general market turbulence have changed the landscape for planning strategies.

When reviewing planning techniques, we must also be mindful of potential changes to the gift and estate tax law. The Tax Cut and Jobs Act of 2017 (TCJA) doubled the lifetime federal gift and estate exemption amount which, with adjustments for inflation, is \$12,920,000 for individuals and \$25,840,000 per married couple in 2023. Barring new legislation, at the end of 2025, the increased exemption amount will sunset, effectively reducing the exemption amount by one half as of January 1, 2026.

The possible reduction in the lifetime exemption amount, increased interest rates and reduced valuations can present challenges but also significant planning opportunities. We encourage you to reach out to your dedicated Private Banker or Eileen Cahill, Senior Managing Director, Financial Planning, to discuss your personal situation and review strategies to help meet your family's long-term goals and objectives.

1 Forbes: <https://www.forbes.com/advisor/investing/fed-funds-rate-history/>

2 Brentmark: <https://www.brentmark.com/%C2%A77520-rates/>

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