

HIGH INTEREST RATES GOT YOU DOWN? CONSIDER A CRAT.

By **JOHN SCHUMAN, JD, CFP®**, Head of the Corient Wealth Transfer Group

Many common wealth transfer techniques are sensitive to interest rates and perform better or worse, depending on prevailing interest rates. We've been blessed to have low interest rates for the last 20 years or so. This has enabled a significant amount of wealth to be created and transferred using techniques such as Grantor Retained Annuity Trusts, sale transactions with grantor trusts, inter-family loans and charitable lead trusts.

For these techniques and others, the Treasury publishes interest rates (called 7520 rates) every month to be utilized in various estate planning techniques. Since 2000, the 7520 rate has ranged from a high of 8.2% in February 2000, to a low of 0.4% in August 2020. The average 7520 rate has been approximately 3.3% from 2000 through the end of 2022. The current 7520 rate is 5%, and the last time the 7520 rate reached 5% was December 2007.¹ So, we are now in territory that we've not experienced for quite some time and that some have never experienced in their careers.

Here are a few wealth transfer techniques that we believe work better when interest rates are high, along with one that should still be considered despite the current environment of higher interest rates.

Charitable Remainder Annuity Trusts (CRATs)

A CRAT is a strategy to transfer assets to charity after the donor has received a lifetime (or term of years) annuity from the transferred assets. The 7520 rate is used to calculate the present value of the annuity retained by the donor. As with any present value calculation, the higher the 7520 rate, the lower the annuity value. When the annuity value is subtracted from the value of the transferred assets, a larger charitable deduction is realized.

When the 7520 rates were sitting at 1%, an individual younger than age 75 couldn't even do a lifetime CRAT, given that a CRAT requires the following three conditions to be met:

- A minimum annuity payment of 5% of the assets transferred
- A charitable deduction of at least 10% of the assets transferred
- Less than 5% probability that the CRAT asset will be exhausted

An interest rate of 1% produced such a larger present value for the annuity that you couldn't pass these tests. With today's 5% 7520 rate, an individual age 25 can do a lifetime CRAT. Moreover, with a

higher interest rate discounting the annuity, a donor may elect to take a larger annuity payment and still meet these CRAT requirements. For example, a person age 75 could reserve an annuity of \$75,970 with today's 7520 rate, whereas the annuity would have been \$50,863 when the 7520 rate was 1%. This gives the donor an annuity that's almost 50% higher with the same charitable deduction.

CRATs are tools used to defer income taxes on the sale of appreciated assets. Since CRATs are tax-exempt trusts, the transferred assets can be liquidated without any income tax. As the donor receives the annuity, each payment carries out taxes from the trust. As a result, the donor has the full value of the transferred property in the CRAT upon which to draw an annuity.

Qualified Personal Residence Trust (QPRT)

A QPRT is a split-interest trust that also utilizes the subtraction method to determine the value a gift. Specifically, the grantor transfers a residence into a trust and retains the right to utilize the residence for a term of years. After the term, the residence passes to the grantor's beneficiary gift tax-free. The 7520 rate is used to calculate the value of the grantor's retained right to utilize the residence, so the larger the 7520 rate, the larger the retained value. As a result, the calculated value of what passes to the grantor's beneficiary, or the gift amount, is lower.

For example, a grantor age 60 who establishes a QPRT with a \$1M residence and retains possession for 20 years would make a gift of \$218,660 at today's 5% 7520 rate. Establishing a similar QPRT when the 7520 rate was only 1% resulted in a gift of \$475,470, requiring more than twice the amount of the gift and estate tax exemption.

QPRTs are likely to become more popular with higher interest rates and with the increased wealth held within residences. We believe this is a fairly straightforward strategy and one that you pretty much

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¹ <https://www.tigertables.com/7520.htm>

forget about until the term of years ends, you sell the property, or make improvements to the property. However, keep in mind that you need to survive the retained term of possession, or else the residence is back in your estate. In addition, there is now a clawback of the estate exemption used to shelter the gift.²

Gifts of the Inflation-Adjusted Exemption

The current high rate of inflation has, in our view, provided an opportunity to give more away, even for those who have already utilized their estate and gift exemptions. From 2022 to 2023, the estate and gift exemption increased from \$12.06M to \$12.92M. This means that an individual can now give away an additional \$860,000 and a couple can give \$1.72M.

This additional exemption also applies to the generation-skipping transfer tax exemption. So, gifts into generation-skipping trusts will remove assets from your estate for estate tax purposes, but more importantly, the assets and the appreciation of these assets in the trust are not taxed in future generations.³ For example, if this additional exemption is used to shelter assets gifted into a generation-skipping trust and the trust assets double a couple of times over 20 years, the \$1.72M would be worth \$6.88M, which would save \$2,752,000 of estate taxes (assuming a 40% estate tax

rate). Accordingly, for those who have significant estates, utilizing the inflation adjustment to their estate, gift and generation-skipping tax exemptions may save a significant amount of future taxes.

Stay With What's Worked

Although we'd prefer an environment of low interest rates for wealth transfer purposes, we have some techniques available that actually benefit from higher interest rates. In our view, higher interest rates should not mean we abandon the techniques that moved significant wealth when rates were at historical lows. Higher interest rates simply mean that those techniques will transfer less wealth than before. So, a GRAT, a sale transaction or inter-family loans will simply require the grantor to receive more money in return, as the result of a higher interest rate. Another way to think about it is these techniques are often referred to as estate "freezing" techniques, meaning that the grantor freezes the growth of his or her estate at a stated interest rate. Today, this "freeze" is at a higher rate compared to a few years ago. Given the transition to higher rates, we have a few new techniques to consider that may supplement what we've been doing for the last couple decades.

² <https://www.govinfo.gov/content/pkg/FR-2022-04-27/pdf/2022-08865.pdf>

³ https://irc.bloombergtax.com/public/uscode/doc/irc/section_2631



JOHN SCHUMAN, JD, CFP®
Head of the Corient Wealth Transfer Group

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