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Will High Inflation Be a Game Changer for Estate Planning?

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We have all felt the profound effects of inflation in our daily lives. From higher prices at the pump to the cost of milk, everything is more expensive. What we are seeing in the supermarket is borne out statistically as well. As of Dec. 14, 2022, the United States' annual inflation rate is 7.1% after having reached a high of 9.1% in June 2022. These are the highest rates since the late 1970s.

To fight inflation, the Federal Reserve (Fed) used the main quiver in its arsenal by raising interest rates. On Dec. 14, 2022, the Fed raised its interest rate from 4.25% to 4.5%, its highest level in 15 years. The Fed has signaled that there could be more rate increases to come.

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The result of the Fed's rise in interest rates is a corresponding rise in the IRS's Applicable Federal Rate (AFR), which generates a rise in §7520 rates. In December 2022, the long-term, annual AFR was 4.34% while the 7520 rate was 5.2%. By way of comparison, the long-term, annual AFR in December 2021 was 1.9% and the 7520 rate was 1.6%.

The rise in interest rates thanks to inflation means the estate planning strategies of barely a year ago are now rendered obsolete because many of our plans focus on the ability to outperform these rates, which becomes much more difficult in a high interest rate environment.

For example, the Grantor Retained Annuity Trust (GRAT), a darling of many planners for the last decade, is directly tied to the 7520 rate. In a GRAT, a grantor contributes an asset into an

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irrevocable trust and retains an annuity for a term based upon the 7520 rate. The property remaining in the GRAT at the end of the annuity term often passes to the remainder beneficiaries free of gift and estate tax.

If the GRAT outperforms the 7520 rate, which is easier to do when rates are low, then the GRAT is "successful" because there will be property available to the remainder beneficiaries after the term. If the GRAT does not outperform the 7520 rate, which is difficult with high interest rates, all the property will be paid back to the grantor and the GRAT will “fail.”

This same idea applies to other popular planning strategies based upon loans and sales to trusts. When the interest rates are low, these strategies are very effective, because it is easier for the borrower to use the cash to beat the interest rate. But when the interest rates are high, these strategies start to make less sense.

With our shifting financial world, where should estate planners turn to in this high interest rate environment?

The first strategy is the simplest: gifting. If inflation is making everything more expensive, then use it to your client’s advantage. From 2018 to 2021, the annual exclusion was $15,000 and in 2022 the annual exclusion was $16,000. Because inflation has become so pervasive, in 2023 the annual exclusion will jump to $17,000. This means that in 2023 your clients can gift up to $17,000 to as many people as they like (think children and grandchildren) free of any gift or estate tax consequences. For a married couple that means they can gift as much as $34,000 per person in 2023.

The same idea applies to the unified tax credit. For 2022, your clients could have gifted or left behind (through their estates) $12.06 million for an individual or $24.12 million for married couples. In 2023, these numbers will jump to $12.92 million for an individual and $25.84 million for a married couple. (In New York, the basic exclusion amount is going to jump from $6.11 million in 2022 to $6.58 million in 2023.) This massive jump on the federal level of almost a million dollars is a direct result of our new inflationary reality.

Another tried and true strategy in a high interest rate environment is the Charitable Remainder Trust (CRT). The CRT is particularly advantageous if you have clients who are retiring and who might be charitably inclined.

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The basic concept of the CRT is similar to a GRAT in that property is transferred to an irrevocable trust for a non-charitable beneficiary (such as the grantor or the spouse) for a term (based on the 7520 rate). Whatever is left in the trust after the term (which must be at least 10% of the fair market value of the initial contribution) goes to charity. The present value of the remainder is deductible as a charitable contribution.

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There are many things to like about CRTs particularly in a world with high interest rates. First, when prices are inflated it often means that investments are inflated. This means that when you sell a particular investment, the capital gains tax could be high because the investment has an inflated value. Capital gains can be a non-issue with CRTs because they are generally exempt from capital gains (just as charities do not have to pay capital gains taxes). Moreover, the higher the interest rate, the higher the value of the charity’s remainder interest, which means your clients can take a larger charitable deduction.

While gifting and CRTs are even more beneficial in a high interest rate environment, they never faded from relevance when interest rates were low. However, there was one strategy that was completely benched over the last decade and is now primed for a comeback—the Qualified Personal Residence Trust (QPRT).

The basic QPRT concept is one whereby your clients can take their home and gift that home at a discount to a trust for a term of years. At the end of the term, the home is transferred to the remainder trust beneficiaries. Your clients can continue to live in the home and pay rent to the new owners free of any estate tax consequences.

For example, if your 65-year-old client owned a $2 million dollar home and placed it into a ten-year QPRT for his children in December 2022, the "taxable value" of the gift was $945,900. In essence your client would be gifting his $2 million dollar home for less than half of its value. The longer the term of the GRAT the greater the savings.

If that same client would have made the same gift of his home into the QPRT in December 2021 when interest rates were low, the taxable value of the gift would have been $1,339,880, significantly greater than the amount in December 2022.

There are a couple of crucial caveats to the QPRT strategy. Most importantly, your client needs to survive the term. If your client dies during the term, the entire value of the property will be included in the client's taxable estate. In April 2022, the Treasury released proposed regulations that could make the consequences of not surviving the term even more severe, but at the end of the day the grantor needs to survive the term for this strategy to be effective.

Another important caveat relates to capital gains. The residence that is transferred to the QPRT will have a carryover basis, i.e., the children will have the same basis as their parents when they sell the property. This means the children will have to pay capital gains on the difference between what their parents paid for the house and what they sell it for.

On the other hand, if the house were to pass to their children outside of the QPRT in the parents' estate, then, under current law, the house would have a "step up in basis" to the date of death value. This means the children could pay virtually nothing in capital gains if they sold the residence shortly after the time of death (assuming there was not a sharp spike in value between the date of death and the date of sale). Thus, the QPRT strategy works best when parents recently purchased a home so that their basis in the home is high and there are no capital gains issues.

The last issue is more practical. Many of our clients love their homes, and they do not want to cede control of their houses even to their children. This last point is often a barrier to entry to QPRTs for clients, although less so now that the taxable benefits are greater on account of higher interest rates.

We know that there are no one-size-fits-all solutions for our clients. The key to effective estate planning is to be adaptable to the world around us. The current inflationary environment as we enter January 2023 presents us with opportunities that we did not have in January 2022. There is no time like the present to (re)adjust our planning strategies from those that worked in a low interest rate environment (like GRATs) to those that reflect our high interest rate reality (like CRTs and QPRTs) and help our clients reduce their taxable exposure in the process.