

Key Planning Considerations in a High Interest Rate Environment

by
Gina M. Nelson
and Daniel Cihanowyz



Since March of 2020, unpredictability and volatility seem to have become the norm. While supply chain issues were largely resolved going into 2022, inflation became a major factor in nearly all facets of life. March 2023 saw Federal Reserve Chairman, Jerome Powell, announce the ninth consecutive increase in interest rates since the Fed began its rate hikes in March 2022.

For estate planners and advisors, a high-interest rate environment presents a unique set of considerations. The ultimate success or failure of many sophisticated estate planning strategies is tied to interest rates, whether high or low. Here, we will delve into several planning areas highly impacted by the current interest rate environment, and we take a look at significant tax changes that may impact planning strategies.

Utilizing the “Power to Adjust”

A rising interest rate environment is an opportune time to re-evaluate one’s investment strategy and asset allocation, focusing on quality over quantity, high conviction investment decisions, and a re-examination of investment objectives, such as taking advantage of higher-yielding bonds for the increased income they provide. Periods of high and rising interest rates require the same strategic thinking as periods of low and falling interest rates, and reviewing the use of the “Power to Adjust” (PTA) is particularly important as trustees navigate these conditions.

The Power to Adjust is a creature of statute that came about largely in the 1990s as a result of Modern Portfolio Theory and the objectives of investing for “total return” (i.e., constructing

a portfolio for both its capital appreciation potential as well as its income component). Trustees have a duty to balance the interests of both current and remainder beneficiaries. Prior to the introduction of the PTA, the balance was often achieved by investing in a portfolio heavily weighted towards producing income and preserving principal, but not so much aimed at growing principal. As the idea of total return investing took hold, it became difficult for trustees to produce income and grow principal concurrently, thus leading to the advent of the Power to Adjust.

While the Uniform Fiduciary Principal and Income Act of 2019 made updates to the PTA language, the most enacted version remains based on the 2008 Uniform Principal and Income Act language in section 104, which reads:

(a) A trustee may adjust between principal and income to the extent the trustee considers necessary if the trustee invests and manages trust assets as a prudent investor, the terms of the trust describe the amount that may or must be distributed to a beneficiary by referring to the trust’s income, and the trustee determines, after applying the rules in Section 103(a), that the trustee is unable to comply with Section 103(b).

The PTA became a particularly powerful tool in the historically low interest rate environment leading up to 2022. With such low yields on fixed income securities across the board, trustees using the PTA could still ensure that income beneficiaries received a fair income payout without having to invest large portions of the portfolio in fixed income. This has allowed

trust principal to grow tremendously, especially since the market lows of the 2008 recession.

While trust companies vary in their approach to calculating and applying the PTA—some calculate a single rate that is used across all accounts subject to PTA, while others calculate each affected account individually based on a variety of factors—one thing is consistent: in the extended period of low interest rates, many trust companies had PTA rates hovering in the low- to mid-2% range, which consequentially resulted in a higher payout to beneficiaries than a true net income distribution.

Now in this environment of rising rates and increasing yields, are trustees nearing a point where accounts using PTA would be best served by converting back to actual net income payments? Using a common 60% Equity/40% Fixed Income portfolio, yields now range from approximately 2.81% to as high as 3.86%, depending largely on the type of fixed income used (corporates, preferred, municipals, etc.). While that number does not net out fees and expenses that would be deducted to reach a net income calculation, it does mean that the use of PTA to increase payments to income beneficiaries is no longer a foregone conclusion. Instead, as rates and yields increase, trustees may find themselves in a position of needing to calculate which method—PTA or true net income—will result in a better payout to current income beneficiary(ies).

Planning Vehicles in a High Interest Rate Environment

Several planning techniques benefit from a reduction in the value of a remainder interest gift that is more easily obtained in a high interest rate environment. The value of such remainder interests within many estate planning strategies is calculated by application of the §7520 rate.

Each month, the Internal Revenue Service publishes the Applicable Federal Rates (AFRs) in Section 1274(d) of the Revenue Code for short-, mid-, and long-term private loans. The AFR is based on data influenced by marketable debt securities of varying durations, such as U.S. Treasury bills, and is used in determining minimum interest rates for private loans. The §7520 rate for a given month is calculated as 120% of the mid-term AFR for that month, rounded to the nearest two-tenths of a percent.

Implementing Charitable Remainder Trusts

While Charitable Lead Trusts (CLTs) ruled the day in the historically low interest rate environment leading up to 2022, Charitable Remainder Trusts (CRTs) now become the more favored strategy in the current high interest rate environment. The Grantor of a CRT receives an annual income distribution (either as a fixed amount or a percentage of assets in the trust) for a fixed term of years as well as an income tax charitable deduction in exchange for an initial gift of assets to be transferred at the trust's termination to a charitable remainder beneficiary. The value of that charitable remainder interest is calculated at the time of the gift using the §7520 rate. A high interest rate environment leads to a higher AFR, driving the §7520 rate higher, which in turn means the CRT will be able to more easily meet minimum thresholds set by the IRS for the value of the remainder interest passing to charity. The higher rate can also reduce the value of the taxable gift at funding and increase the value of the charitable deduction.

Remember QPRTs?

In a Qualified Personal Residence Trust (QPRT), a Grantor

transfers a residence into trust and may retain the right to reside in the residence thereafter for the duration of the trust term. After the term (a fixed number of years), the trust will terminate, and the residence will pass to the trust beneficiaries, often the Grantor's descendants. Those beneficiaries may then rent the home back to the Grantor for fair market value. The value of the remainder interest in the home is calculated using the §7520 rate at the time of the gift to the trust. In a higher rate environment, this means that the value of the grantor's right to use the residence for the duration of the trust increases, thereby reducing the value of the initial taxable gift of a future interest made to the trust. As the §7520 rate increases, the value of the taxable gift made to the trust decreases which makes the QPRT an increasingly attractive planning strategy as rates continue to rise.

What about GRATs?

The success or failure of a Grantor Retained Annuity Trust (GRAT) is commonly judged by whether the assets transferred to fund the trust appreciate at a rate that is greater than the §7520 rate. If assets appreciate at a greater rate, that surplus is transferred to the GRAT beneficiaries gift tax free when the trust term ends. As interest rates climb, so too does the §7520 rate, and the margin for excess appreciation begins to shrink. This makes GRATs less attractive in a high interest rate environment. However, if the Grantor has utilized all or most of their lifetime gift tax exemption, and they have assets likely to appreciate, utilizing a GRAT may still offer certain advantages.

Changing Tax Exemptions and New Opportunities

The higher interest rate environment is expected to remain in place as the Fed battles inflation and tries to regain price stability. As a direct result of inflation, exclusion and exemption amounts that automatically adjust for inflation saw significant increases in 2023. While inflation does erode purchasing power, it is a double-edged sword that can positively adjust numerous allowances that provide benefits.

For gift and estate taxes, the annual gift tax exclusion increased to \$17,000 in 2023. With gift splitting, this means a married couple can gift \$34,000 in 2023 to any single recipient without needing to file a gift tax return and triggering a taxable gift. Additionally, the federal estate tax exemption increased to \$12,920,000 per person in 2023 (\$25,840,000 per married couple). Many people used their full exemption amount in late 2020, in anticipation of estate tax law changes that never materialized, so for those who did not make subsequent gifts, there is now an additional \$1,340,000 in unified credit available for single filers and \$2,680,000 for married couples over and above the 2020 amounts. It is worth noting that the increased tax exemption is set to expire at the end of 2025 and return to 2017 levels, adjusted for inflation. For clients who did significant planning during the period of lower interest rates, the increased exemption allows for, among other things, vehicles that take advantage of the higher interest rate environment.

Also of note, the SECURE Act 2.0 (the "Act"), which passed in December 2020, introduced the potential for a beneficiary of a 529 College Savings Plan to roll unused savings into a Roth IRA without tax or penalty. This may benefit families who "over saved" for college education and want to assist newly working young adults in jumpstarting their retirement savings. The

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provision, however, has some limitations: the 529 Plan account must have been open for at least 15 years, and the total amount rolled over cannot exceed (a) \$35,000 or (b) the total contributions to the account since creation (i.e. capital appreciation cannot be rolled into the Roth). Also note that such transfers do count toward a given tax year's Roth IRA contribution limit.

While some estate and tax planning strategies work well across economic cycles, some tools that have not seen favor over the last several years are now well suited under the current environment. Similarly, trustees who have relied on tools such as the Power to Adjust may now find themselves in a position of re-examining the best outcome for beneficiaries in these circumstances. These changes, along with those in tax laws and exemptions, give planners significant opportunity to help clients best take advantage of existing economic conditions. Naturally, any investment involves a certain degree of risk; these recommendations serve as the starting point of a discussion rather than a basis on which decisions should be made. Please contact an advisor for further information.



Gina M. Nelson is Senior Vice President and Head of Fiduciary Services at Chilton Trust with over 15 years of experience in various trust and estate roles. She has spoken on panels at several key industry events, including the Delaware Trust Conference and the Mourant Ozannes International Trust and Private Client Conference. Ms. Nelson began her career

practicing law and opened her own practice where her focus was estate planning and trust and estate administration.



Daniel Cihanowyz is Senior Trust Officer at Chilton Trust with over 12 years of experience in trust and estate administration and relationship management. Mr. Cihanowyz attended Campbell University as a member of the nation's only post-graduate Trust and Wealth Management Program where he received his Master's and Bachelor's degrees in Business

Administration with a concentration in Wealth and Investment Management and a Minor in Financial Planning. Mr. Cihanowyz holds both the Certified Trust and Fiduciary Advisor (CTFA) and Accredited Trust Financial Advisor (ATFA) designations.

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