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Wealth Planning in a Higher Interest Rate Environment

Opportunities exist to put new estate planning structures in place and recommit to sound financial planning and debt management

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Key points

- The marked increase in rates has upended thinking about estate planning techniques and curtailed the era of “cheap money” enjoyed since the Great Recession
- It’s helpful to consider what opportunities the current interest rate environment may offer for your estate and financial plan

Faced with the highest rate of inflation in almost 30 years, the Federal Reserve (Fed) began hiking interest rates in early 2022. In just over two years, the federal funds rate has increased from just above zero to a current target ceiling of 5.50% as of July 2024.* While financial professionals and the media debate the future trajectory of interest rates, anyone considering their planning is left to work with the current elevated interest rates. It can be helpful then to consider what opportunities the current interest rate environment offers. The climb in rates has altered thinking about estate planning techniques and curtailed the era of "cheap money" enjoyed since the Great Recession. Yet opportunities abound to put into place new estate planning structures and to recommit to sound financial planning and debt management.

How interest rates relate to estate planning

Interest rates are important for more than just banking. Several types of estate planning strategies use numbers derived from the federal funds rate.

- Applicable federal rates (AFRs): The Treasury issues the short-term, mid-term, and long-term applicable federal rates each month based on prevailing interest rates. These rates attach to promissory notes when loans are made among family members without banks involved.
- Section 7520 rate: §7520 is a factor used in making various calculations (remainder interests, charitable deductions, minimum thresholds) for sophisticated estate planning strategies.

Estate planning strategies: What's in and what's (maybe) out

Several estate planning strategies that have enjoyed advantages in recent years of near-zero interest rates have lost much of their appeal. Meanwhile, other strategies that can benefit from higher interest rates may warrant a new look.

Strategies that can benefit from higher rate environments:

Charitable remainder trust (CRT): CRTs provide for an annual payment to the grantor who funds the trust with an eventual distribution made to charity when the trust terminates. Upon funding the trust, the grantor gains an income stream and can also benefit from a charitable deduction. Prevailing interest rates directly determine the size of the charitable deduction associated with this technique. Additionally, the IRS imposes certain requirements on this type of trust that may be easier to satisfy when the §7520 rate is higher. Assets owned by a CRT are not subject to tax when sold. These types of trusts may be useful to business owners who can fund the trust with business interests prior to a sale of the business and delay capital gains tax from the sale.

Qualified personal residence trust (QPRT): QPRTs are used to pass real estate to subsequent generations for a minimized gift tax value. This strategy may be attractive for those who have valuable residences and want to move the residence out of their taxable estates in a potentially advantageous way. As the §7520 rate increases along with interest rates, the taxable gift aspect of this strategy decreases, making the QPRT a more attractive strategy with higher interest rates.

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Strategies that have lost some appeal:

Intrafamily loans: Intrafamily loans can be an effective way for wealthier family members to move wealth to other family members at interest rates using the AFR. Rising interest rates have an obvious dampening effect on loans. Although the AFR rises along with interest rates, intrafamily loans haven't entirely lost their appeal as they may still present a more attractive alternative to commercial loans.

Grantor retained annuity trust (GRAT): A GRAT is a type of trust that provides for an annual payment to the grantor, the trust creator who funds the trust, and then a distribution to beneficiaries at the end of the trust's term. The final distribution can pass assets on at a minimized gift tax value. This strategy is more likely to be successful when interest rates are low and the assets inside the trust can appreciate at a rate higher than the prevailing interest rates.

Charitable lead trust (CLT): A CLT is a type of trust that provides for charitable payments during the trust's term with a final distribution to noncharitable beneficiaries when the trust terminates. This type of trust usually performs better when interest rates are low, and the value of the assets going to noncharitable beneficiaries can increase at a rate higher than the prevailing interest rates. Higher interest rates lead to a higher §7520 rate for this technique, making it harder to pass on value when the CLT terminates.

Sale to an intentionally defective grantor trust (IDGT): A cornerstone of a sale to an IDGT is a promissory note bearing interest at the AFR. A low-interest-rate sale of an asset with appreciation potential makes this an efficient strategy when rates are low. Conversely, a higher AFR makes this technique look less appealing. However, there are still aspects of a sale to an IDGT that are appealing: currently depressed asset values, fractional interest discounts, and the potential to refinance promissory notes in the future when rates drop mean that you should not write off this strategy entirely.

Consider financial planning options

While considering sophisticated estate planning strategies, the current environment is a time to evaluate your financial foundations. The challenges of higher interest rates mean that you should take steps to be sure you have solid cash flow, debt management, and other personal finance fundamentals.

Budgeting and prioritizing paying down debt: Having a good understanding about your available cash flows and what is remaining after meeting expenses can put you in a better position to deal with higher interest rates. If you have a clear picture of your budget, you can then prioritize where to direct any remaining funds. Evaluate your debt costs and determine whether to direct excess funds to investments or to pay down your borrowing that is the highest cost first, depending on your financial goals and objectives. You should also consider how loans or other credit you have outstanding may reset in the future, and how that may impact borrowing costs once any adjustments occur. If your borrowing costs are tied to a loan that has a fixed rate that could reset, such as an adjustable-rate mortgage or that is based on an index that can increase, such as a home equity line of credit (HELOC), it is important to identify how higher interest rates will influence your costs.

Maintain a reserve fund: Part of your budgeting process should also include building a reserve fund that you can rely on for unanticipated spending needs that arise. The ability to use the fund as a buffer against higher expenses can help you avoid being placed in a situation where you need to raise cash by liquidating investments or tapping into an available line of credit and paying interest. Higher interest rates can have a positive side as you may be able to earn a better yield on your cash as short-term interest rates have increased.

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Sensitivity analysis and hedging: If you are unsure about how rising rates may impact your borrowing, ask your lender to conduct a sensitivity analysis to stress test your loans under various scenarios to illustrate how your personal finances or business investments might be affected.

Refinance or consolidate floating rate debt for fixed rate: Interest costs tied to floating indexes have risen faster than long-term rates, so there may also be an opportunity to refinance your floating rate debt into longer-term fixed rate debt to lock in lower interest rates. The current Prime rate as of July 16, 2024 is 8.50%,** floating, versus longer-term fixed mortgage rates that are still below this level. Refinancing a HELOC or other floating rate debt into a first or second mortgage may lower your interest rate. Refinancing debt can involve closing costs as well as changes to your monthly payment obligations, when trading interest-only repayment on a line of credit for a fixed monthly principal-and-interest repayment schedule with most mortgages. These factors, as well as how long you plan to own the home, should be weighed against potential interest savings.

Pay off debt versus investing: Determining whether to use your excess cash flow or investment assets to pay off debt or to continue to contribute to your savings and remain invested can often be a matter of personal preference. While you may have the opportunity to earn greater returns from investments, many prefer the satisfaction they feel from retiring their debt. In a higher interest rate environment, this financial analysis becomes even more important.

If you are considering selling appreciated assets at a gain, you may also have to pay tax on the profits you capture through the sale, subject to any tax loss harvesting. Remaining invested could help you mitigate capital gains taxes and may allow for appreciation of invested assets. Another key consideration is how your assets are currently invested, and how they relate to your long-term goals. This may be a deciding factor in whether it makes sense to sell assets to reduce your debt.

If you decide to sell assets to provide funds to pay down existing debt, this could derail your long-term investment plans. If your assets are positioned for growth, and you sell them to pay off debt, you may have limited the opportunity for those assets to continue to appreciate to meet future spending goals. While you may reduce or eliminate mortgage payments, it is important to remember that those savings could be used to replace previously invested assets to keep long-term goals in reach. Instead of selling assets, if you remain invested, and allow time in the market to provide returns that may exceed the cost of borrowing over the long term, you may benefit from utilizing leverage to boost your wealth. When facing higher interest rates, investments may need to be allocated in a more aggressive manner, or future expected returns from those holdings may not exceed the cost of borrowing. These decisions should also factor in whether ongoing savings or current investment holdings are directed toward taxable or tax-deferred accounts, and if you currently benefit from a mortgage interest deduction if you itemize deductions on your tax return.

Higher rates and investment income: If inflation moderates, current yields available in fixed-income investments may finally provide investors in this asset class with interest payments that make bonds more attractive. After years of low interest rates and accommodative monetary policy, considering fixed-income investments and their role in your portfolio should also be evaluated. It is important to talk to your investment advisor about how fixed-income investments could affect your investment strategy and the risks of further rate increases on the value of your investments.

By design, the Federal Reserve uses interest rates to cool the economy and tame inflation. The resulting headwinds to economic growth and personal finance can seem challenging, but all is not lost with regards to planning. A period of elevated interest rates presents planning opportunities that the savvy planner can leverage in addition to the obvious challenges.

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As part of the Wilmington Trust Emerald Family Office & Advisory® team, Matthew is responsible for developing customized wealth management strategies and financial plans for successful individuals, families, and business owners. He works closely with other professional and family advisors to analyze financial positions and develop plans to help clients achieve future personal and financial goals.

Matthew, who joined M&T Bank in 2009, holds a bachelor's degree in finance from Canisius College and earned the CERTIFIED FINANCIAL PLANNER™ designation in 2011, and the CHARTERED FINANCIAL CONSULTANT® designation in 2015 from The American College. Matthew has also received the ACCREDITED ESTATE PLANNER® designation from the National Association of Estate Planners and Councils in 2019. He is an active member of the Financial Planning Association of Western New York and the Western New York Estate Planning Council.

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* Source: New York Federal reserve, www. newyorkfed.org/markets/reference-rates/effr

** Source: www.wsj.com/market-data/bonds/moneyrates

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