EVALUATING ESTATE PLANNING TECHNIQUES IN A RISING INTEREST RATE ENVIRONMENT

Kelly M. Perez
Executive Director, Wealth Advisor
J.P. Morgan Private Bank, Dallas, Texas

2022 Stanley Johanson Estate Planning Workshop
December 2, 2022
University of Texas School of Law

EVALUATING ESTATE PLANNING TECHNIQUES IN A RISING INTEREST RATE ENVIRONMENT

TABLE OF CONTENTS

EVALUATING ESTATE PLANNING TECHNIQUES IN A RISING INTEREST RATE ENVIRONMENT

I. INTRODUCTION

Estate planning and tax professionals have an extensive selection of wealth transfer tools to choose from to help individuals or families transition wealth to the next generation, whether be it to loved ones or to carry out charitable intent in a tax-efficient manner. The method, or methods, of transfer used will depend on many factors including the donor's objectives, the donor's net worth and liquidity needs, the type of asset to be transferred, the fair market value (FMV) of the asset, potential asset performance, the donor's transfer tax exemption usage and other tax (and non-tax) goals, the complexity of the transaction, and the ability of the donor, trustee, and other relevant parties to properly administer the vehicle in accordance with state and federal law. The donor's desire to minimize, or indifference to, a potential 40% federal estate tax rate also plays a large factor in creating a comprehensive wealth transfer plan.[1]

In some cases, wealth transfer may not be considered time-sensitive, as, for example, when a donor wishes to fund a dynasty trust with cash for the benefit of her mature and financially independent adult children and has plenty of gift and generation-skipping transfer (GST) tax exclusion available to use on such gift.[2] But in other cases, such as when a donor is considering selling her closely-held business in the near future, time is of the essence. The possibility of a dramatic change in the FMV of the asset coupled with a vanishing opportunity for claiming valuation discounts (as may be reflected in a qualified appraisal) will no doubt influence the timing of a transfer.[3] Other factors such as the donor's age, the health of the relevant parties, and the potential for legislative changes play a role in timing as well.

The current interest rate environment has a consequential effect on whether certain estate planning techniques will be effective to meet a donor's wealth transfer goals. Interest rate fluctuation is a key factor in determining not only what wealth transfer techniques to consider, but also when it makes the most sense to engage in such planning. Many estate planning techniques are interest rate sensitive. Some will perform more effectively when interest rates are high, and others when rates are low. Some remain unaffected by rate variations. The Federal Reserve has been raising the federal funds rate since March 2022 in response to rising inflation rates. The benchmark federal funds rate has risen from close to zero in March to a range between 2.25% and 2.5% as of September 2022. These increases have a domino effect on interest rates used in various other contexts, and the interest rates used in common estate planning techniques, such as the Applicable Federal Rate and the Section 7520 rate, are no exception. Though rates have rapidly increased this year, they are still relatively low compared to rates over the last few decades. Even though certain planning techniques that perform better at lower interest rates may not prove to be as successful as they

[1] I.R.C. § 2001(b) provides the computation of estate tax and § 2001(c) provides the estate tax rate schedule (40% tax rate); *see* §2503 for gift taxes; and § 2641(b) provides the tax rate for GST tax. These taxes do not apply to the transfer of money or other property to an organization described in paragraph (4), (5), or (6) of I.R.C. § 501(c) and exempt from tax under I.R.C. § 501(a), for the use of such organization. Any references herein to the "Code," "I.R.C." or "Section" refer to the Internal Revenue Code, Title 26, United States Code, and the Treasury Regulations promulgated thereunder. All I.R.C. citations in this article refer to the current statute unless otherwise stated.

[2] In this article, the terms "lifetime exclusion" or "exclusion amount" generally refer to the amount that an individual can give or pass on to others during one's lifetime or at death without triggering the payment of transfer tax, at a current 40% tax rate. Under the Tax Cuts and Jobs Act of 2017, the exclusion amount applicable to gift and estate, and GST tax, respectively, is $10 million, indexed to inflation, and is $12,060,000 for 2022. After December 31, 2025, the exclusion amount is scheduled to revert to the pre-TCJA amount of $5 million, indexed to inflation. *See* I.R.C. §§ 2010; 2505; and 2631; *see* Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97 (2017). TCJA's full title is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

[3] "Fair market value" for transfer tax purposes is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Treas. Reg. § 20.2031-1(b); Treas. Reg. § 25.2512-1. *See also* Justin P. Randome and Vinu Satchit, "Valuation Discounts for Estate and Gift Taxes," J. ACCT. (July 1, 2009).

would be using 2020-level interest rates, those techniques remain valuable and effective wealth transfer options, both comparatively (based on historic interest rates) and absolutely.

In this article we will (1) briefly discuss market conditions leading to the Federal Reserve System's rate hikes, (2) review the relationship between interest rates and transfer tax planning, (3) examine several interest rate sensitive wealth transfer techniques and (4) assess their efficacy in a rising interest environment.

II. MARKET VOLATILITY, INFLATION AND INCREASED FEDERAL RATES

A. Covid-19 pandemic and market volatility

Since the start of the Covid-19 pandemic in early 2020, global economies have been on what one can fairly describe as a white-knuckled amusement park ride. On February 19, 2020, the S&P 500 (S&P) closed at a record high while investors continued to weigh the coronavirus' potential impact on the global economy.[4] As the news about, and fear of, the pandemic shortly thereafter spread, stock prices quickly tumbled, fast-tracking the S&P and the Dow Jones Industrial Average (Dow) into a bear market. On February 24, 2020, the U.S. experienced the first Covid-related market decline when the S&P fell 3.35% to close at 3,225.89, its worst day in two years.[5] This decline erased the S&P's year-to-date gain.[6] Market sell-offs only intensified leading into the next month.

On March 12, 2020, the global stock market crashed; the S&P dropped 9.51%, one of the worst percentage drops that index had ever experienced.[7] Then, on Monday, March 16, 2020, the S&P dropped nearly 12%, marking the third-worst daily percentage loss in U.S history.[8] March 23, 2020, saw the Covid-related market bottom when the S&P closed at 2,237.40, down 34% from the onset of the pandemic.[9] It had taken the S&P only 22 trading days to fall from the February 19 record high, making it the fastest drop of this magnitude in history.[10] The S&P did not recover to its pre-pandemic highs until June 2020.[11] The national economy, as measured by real (inflation-adjusted) gross domestic product, fell by 3.5% year over year in 2020 for the first time since the 2009 sub-prime mortgage crisis, referred to as the "Great Recession."[12]

The 2020 economic nose dive was caused predominantly by the pandemic, a drop in oil prices and the potential of a U.S. recession. Though the uncertainty of the time caused tension and instability for many, if not most Americans, the U.S. government came to the aid of individuals, families and businesses through various stimulus packages designed to provide direct relief to those affected by pandemic-related financial

[4] The Standard & Poor's 500 Index is a market capitalization-weighted index of five hundred leading publicly-traded companies in the U.S. *See* Fred Imbert, "S&P 500 and Nasdaq jump to record high, Dow climbs more than 100 points," cnbc.com, February 19, 2020.
[5] Matt Philips, Jason Horowitz and Choe Sang-Hun, "U.S. Stocks Plunge as Coronavirus Crisis Spreads," The New York Times online, February 24, 2020.
[6] Fred Imbert and Eustance Huang, "Dow plunges 1,000 points on coronavirus fears, 3.5% drop is worst in two years," cnbc.com, February 23, 2020.
[7] Sean Burch, "Black Thursday: Dow Suffers Biggest Point Drop Ever," Yahoo.com, March 12, 2020.
[8] Wikipedia, List of largest daily changes in the S&P 500 Index, Retrieved September 10, 2022.
[9] William Watts, "The Stock Market Hit Its COVID Low 2 Years Ago Today," MarketWatch, March 23, 2022.
[10] Yun Li, "This was the fastest 30% sell-off ever, exceeding the pace of declines during the Great Depression," cnbc.com, March 23, 2020.
[11] Brian Scheid, "Stocks Surge, Comfort Grows as Market's Fear Gauge Falls to Pre-Pandemic Levels," S&P Global Market Intelligence, June 29, 2021.
[12] U.S. Bureau of Economic Analysis, "News Release: Gross Domestic Product, 4th Quarter and Year 2020 (Advance Estimate)," January 28, 2021. The sub-prime mortgage crisis refers to the U.S. recession, lasting from December 2007 to June 2009, and the global recession of 2009.

Title search: Evaluating Estate Planning Techniques in a Rising Interest Rate Environment

Also available as part of the eCourse
2022 Stanley M. Johanson Estate Planning eConference

First appeared as part of the conference materials for the
2022 Stanley M. Johanson Estate Planning Workshop session
"Evaluating Estate Planning Techniques in a Rising Interest Rate Environment"