Wealth Planning in a High Interest Environment

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Experts are currently predicting the Federal Reserve rate could reach as high as 5 percent during 2023, a rate not seen since 2007. Now that we are no longer enjoying lower interest rates — and interest rates continue to rise, it is important to examine some tax strategies that are better suited for a high interest rate environment.

Intra-Family Loans

Intra-Family Loans are an effective way to transfer money to family members without using your annual gift tax exclusion ($16,000 per person in 2022 and scheduled to increase to $17,000 per person in 2023) or lifetime gift tax exemption ($12.06 million in 2022 and scheduled to increase to $12.92 million in 2023). This strategy can help a younger relative purchase a home, start a business or to invest.

To be a valid loan, the family member must be legally obligated to repay the loan as they would with a loan from a bank. The note must charge interest of at least the applicable federal rate (which is the lowest rate the Internal Revenue Service (IRS) allows), but also can have flexible terms that favor the borrower. If desired the lender can use his annual gift tax exclusion to forgive loan principal. The lender is required to recognize the interest income it receives from the borrower's payments each year.

In a high interest rate environment and volatile market, the lender relative may prefer a guaranteed rate of return in the form of interest rather than investing in the market. When interest rates are lowered in the future, the loan can be refinanced to adopt the lower rate if that is desirable to the family's situation.

Qualified Personal Residence Trust (QPRT)

A QPRT is a trust where the Grantor transfers his or her personal residence to a trust. It is a useful strategy to transfer the Grantor's personal residence to a family member while lowering the taxable value of the gift.

With a QPRT, the Grantor retains the right to reside in the personal residence for a set term. At the end of the term, the personal residence will be distributed to the remainder beneficiary. If the Grantor survives the set term, he or she can then pay rent to continue to live at the personal residence if desired. The rent payments can further reduce the Grantor's estate. Each year, the IRC 7520 rate determines the value of the right to reside in the personal residence. Each year this value is deducted from the value of the personal residence at the time it was contributed to the trust. As interest rates continue to rise, this strategy is an effective way to reduce the taxable amount of the gift of your personal residence. It should be noted, however, that the Grantor is required to survive the term of the trust. If the Grantor dies before the end of the trust term, then the date of death value of the personal residence will be included in the Grantor's estate.

Keep in mind that the lifetime gift tax exemption was drastically increased in 2017 with the Tax Cuts and Jobs Act. In 2026, the lifetime gift tax exemption will decrease to $6.4 million. By creating a QPRT before 2026, it allows the Grantor to use the larger lifetime gift tax exemption amount when the personal residence was contributed to the trust rather than the reduced lifetime gift tax exemption amount on the date the remainder beneficiary receives the personal residence.

It is important to remember, however, these are personal financial strategies that depend on your individual circumstances and the goals you wish to accomplish. ■

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