THE WALL STREET JOURNAL.

Estate Planning: How to Adjust to Rising Rates

Affluent families should consider how changing rate environment might affect their estate plans

THE WALL STREET JOURNAL.

Now that the Federal Reserve has taken the long-awaited first step in raising interest rates, affluent families should consider how a changing interest-rate environment might affect their estate plans.

People may want to take advantage of some wealth-transfer approaches before rates climb even further, while keeping other possibilities in mind for coming years if rates continue rising from today's very low levels.

Interest rates can affect strategies for minimizing estate taxes and taking advantage of income-tax breaks in a couple of ways. Some approaches are dependent on investments earning more than a "hurdle" interest rate, so they are more attractive when rates are low. Also, interest rates are used to figure the value of a lump sum or series of payments in the future, which can affect income-tax deductions and the magnitude of potentially taxable gifts to heirs. The present value of a future sum is lower when interest rates are higher.

Here are two strategies that work best when rates are low and two that could be worth a closer look if rates keep rising.

Intrafamily loans

Wealthy individuals sometimes lend money to their adult children to invest. Or they transfer a promising investment to the children, taking back a promissory note on which the children pay interest. Any net investment return above the loan rate is effectively a tax-free transfer of wealth to the younger generation.

Tax rules spell out the minimum interest rate the parents must charge to avoid having a below-market-rate loan treated as a taxable gift. That rate this month ranges from 0.56% to 2.61%, depending on the term of the loan.

The higher rates rise, the higher the rate of return borrowers will need to make a profit and that could make the strategy less attractive, says Matthew Brady, senior director of wealth planning for Wells Fargo Private Bank in San Francisco. Some people who have already used this strategy may want to refinance now to lock in current low rates and extend the term of the loan, he says.

Grantor retained annuity trusts

GRATs are often used by wealthy individuals who wish to pass down appreciating assets to heirs without taking a big gift-tax hit and to lower their overall estate-tax burden.

They are set up for a term of two years or more and often funded with assets with high growth potential, including private equity, says John Voltaggio, managing director and senior wealth adviser at Northern Trust Corp. in New York.

The grantor (say, a parent) who creates the GRAT usually receives annuity payments from the trust that add up to the asset's original value plus a market-based interest rate set by tax rules. If the assets in the GRAT generate a total pretax return that exceeds that hurdle rate, the excess return passes to heirs free of gift and estate taxes, says Mr. Voltaggio.

If you think interest rates are going to continue rising, you may want to set up a new GRAT to lock in today's rate, says Mark Parthemer, senior fiduciary counsel at Bessemer Trust in Palm Beach, Fla.

Qualified personal residence trusts

One strategy that could be more attractive when rates are higher is the use of a trust to pass a primary residence or vacation home to heirs, while the grantor retains the right to live in the house for a number of years.

A qualified personal residence trust essentially freezes the value of the property for gift- and estate-tax purposes at the time of creation.

The potentially taxable gift is the present value of the asset in a certain number of years, Wells Fargo's Mr. Brady says. "In a higher-rate environment, the present value of the asset is lower, therefore the gift value is lower," he says.

Charitable remainder annuity trusts

Philanthropically minded people put assets into CRATs and name one or more charities as the ultimate beneficiary while continuing to draw income during their lifetime.

The grantor is allowed a tax deduction at the time the CRAT is funded for the remainder interest that will ultimately pass to the charity.

When interest rates are high, the present value of the income stream the donor receives is lower, making the value of the gift to the charity higher for tax purposes.

"The higher the interest rate at the time a CRAT is funded, the greater the tax deduction," says Kevin Koscil, a lawyer at White and Williams LLP in Philadelphia.

Write to Veronica Dagher at veronica.dagher@wsj.com