

Key Wealth Institute

Planning With Purpose: Adapting Strategies to Shifting Rates

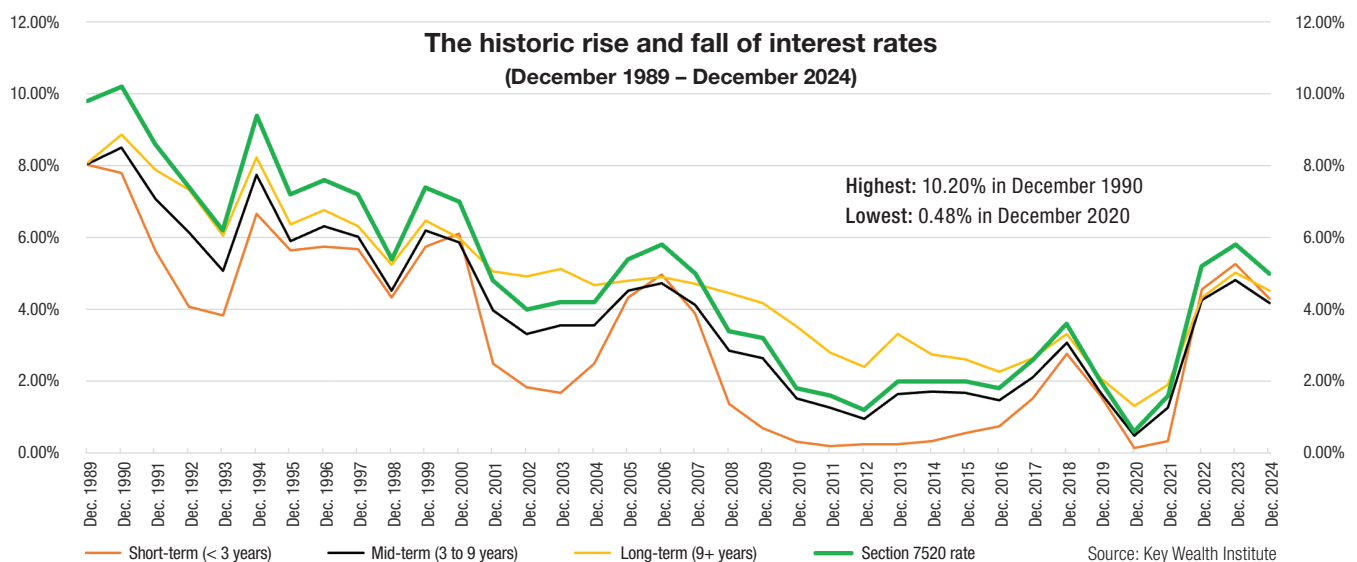
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The effectiveness of many financial planning strategies depends on interest rates. Some work better when rates are low; others lose their edge when rates rise. If your goal is a large tax deduction or income stream, the prevailing interest rate can significantly affect results.

However, before we look at various strategies and how they are affected by changes in interest rates, let's review the history of interest rates.

Various financial planning techniques use the Internal Revenue Service's (IRS) Section 7520 rate, a benchmark linked closely to current interest rates published monthly. In early 2025, the IRS 7520 rate was in the 5.2% to 5.4% range. That's an increase of more than 300% from the rates in 2022, when they were just 1.6%.

This article focuses on the impact of short-term rates. However, in the context of the long-term trend, current rates remain relatively low. Based on the following chart, the long-term low was December 2020, when the rate hit 0.48; the high was 10.2% in December 1990.



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Impact of interest rate changes on charitable trust planning

Two main types of trusts are used in charitable planning.

1. Charitable remainder trust (CRT)

A donor sets up an irrevocable trust for either a specified period (not to exceed 20 years) or for the remainder of their life. The donor receives income during the term of the trust and the charity receives the remainder at the end of the term. The donor receives a current income tax deduction for the present value of what the charity will receive in the future, requiring a calculation based on the current Section 7520 interest rate.

A CRT can be structured in two ways. One option provides fixed annual payments (a charitable remainder annuity trust, or CRAT). The other pays a percentage of the trust's value each year, varying with investment performance (a charitable remainder unitrust, or CRUT).

Example:

Jane Smith, age 64, wants to fund a CRAT for \$1 million. It will pay her 5% of the initial value annually (distributed quarterly) for 15 years and the trust's growth rate is 7% per year. Assuming a low Section 7520 interest rate (say 1.2%, which is what we saw a few years ago) her charitable deduction would be \$314,283.

As interest rates increase, the present value of the payments to the donor decrease, resulting in an increase in the value of the remainder, which goes to the charity (thus increasing the charitable deduction). So, if Jane set up the CRAT when interest rates were at 5.4%, the charitable donation would have increased to \$484,665.

Section 7520 Rate	First Year's Income	Present Value of Annuity	Possible Current Year Income Tax Deduction	Donor's Deduction as a Percentage of Amount Transferred
5.4%	\$50,000	\$515,335	\$484,665	48.467%
1.20%	\$50,000	\$685,283	\$314,283	31.428%

Note: This calculation is for illustrative purposes only. It assumes use of the 2010CM Actuarial table.

2. Charitable lead trust

The charity receives an income stream for a period of time, then the trust terminates with the proceeds distributed to the beneficiaries (typically family members such as children). Like CRTs, charitable lead trusts may provide either a fixed (CLAT) or variable (CLUT) income stream to the charity. Since the value of the stream of payments to the charity is worth less as interest rates increase, the value of the current tax deduction correspondingly decreases as interest rates increase.

Example:

Jane Smith is considering funding a charitable lead annuity trust with a 15-year term and a 5% annual payout (paid quarterly) to the charity with a growth rate of 7% per year. If the Section 7520 interest rate is just 1.2%, the charitable deduction available to the donor is \$685,717. However, if interest rates increase to 5.4%, the deduction drops to \$515,335.

Section 7520 Rate	First Year's Payment	Remainder Interest	Possible Current Year Income Tax Deduction	Donor's Deduction as a Percentage of Amount Transferred
5.4%	\$50,000	\$484,665	\$515,335	51.533%
1.20%	\$50,000	\$314,283	\$685,717	68.572%

Note: This calculation is for illustrative purposes only. It assumes use of the 2010CM Actuarial table.

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Charitable gift annuities (CGA) are a third type of charitable vehicle affected by the variability in interest rates. In these arrangements, the donor makes a gift to a charity and receives a fixed annual income payment for life. The interest rate affects both the annuity's payout rate and the deduction the donor can claim. The payout rate is largely based on the American Council on Gift Annuities (ACGA) suggested maximum rates.

Several factors influence payout rates, but the current federal funds rate is one of the most important. The income tax deduction available to the donor is the donated amount less the present value of the expected annual payments. That translates into a higher income

tax deduction for the donor as interest rates increase (if the payout from the charity does not change).

There is a significant correlation between current interest rates and the gift annuity payout rate for the CGA.

Example:

As interest rates rose through 2022, one charity increased its payout rate for a 70-year-old from 5.3% to 5.9%. So, if a donor gave a charity \$1 million in 2023 as opposed to 2022, their annual payments would be \$6,000 a year more for their entire life. In addition, the value of the tax deduction also would have increased from \$348,291 to \$433,423 because of the rise in interest rates.

Section 7520 Rate	Gift Annuity Payout Rate	Annual Payment	Possible Income Tax Deduction
4.60%	5.9%	\$59,000	\$433,423
1.60%	5.3%	\$53,000	\$348,291

Note: This calculation is for illustrative purposes only. It assumes use of the 2010CM Actuarial table.

Other estate planning tools

Several other tools are designed to transfer future appreciation out of the donor's estate. Their effectiveness changes dramatically with changing interest rates. These tools are most beneficial to people who have either exhausted or want to preserve their lifetime gift/estate exemption (\$13,990,000 for 2025) and want to transfer assets tax free to children or other beneficiaries. We will review these four:

1. Grantor retained annuity trust (GRAT)

A GRAT lets the grantor place assets into a trust for a set period. During that time, they receive payments of the original principal plus interest (again using the IRS 7520 rate). Any growth above that rate passes on to the beneficiaries free of gift taxes.

Example:

A grantor set up a two-year GRAT with \$1 million with the next generation as the beneficiary, and the GRAT earned 8% per year. If the IRS 7520 was at 1.20%, the amount remaining after the term passing gift-tax free to the next generation would be almost \$109,000. However, if the rate increased to 5.4%, the amount remaining would have dropped to less than \$43,000 because the required rate of return hurdle (i.e., the IRS 7520 rate) was much higher.

Section 7520 Rate	Annual Distribution to the Grantor	IRS Value of Remainder for Gift Tax Purposes	Actual Remainder to Family (After 2 Years)
5.4%	\$540,862	\$0.02	\$ 42,622
1.20%	\$509,009	\$0.00	\$108,899

Note: This calculation is for illustrative purposes only. It assumes use of the 2010CM Actuarial table.



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2. Sale to an intentionally defective grantor trust (IDGT)

An IDGT is an irrevocable trust focused on estate tax savings. IDGTs can be an effective way to transfer future appreciation from a rapidly appreciating asset with little or no gift or estate tax cost. They are ignored for income tax purposes but not for estate and gift tax purposes. It is this inconsistent treatment of income versus estate/gift taxes that gives rise to use of the term “defective.”

The IRS has ruled that a sale or other transaction between an IDGT and the grantor does not result in any capital gain or loss, or any other income tax consequences. Therefore, a grantor can sell appreciated assets to their IDGT without realizing any capital gain. Since the transaction is a sale for fair market value, there’s no taxable gift. The trust issues a note with an interest rate at or above the applicable federal rate (AFR), which the IRS publishes monthly. The AFR is similar to but different from the IRS 7520 rate.

Example:

A grantor seeded the trust with a \$100,000 gift and sold an asset worth \$1 million to their IDGT and took back a nine-year note with a mid-term AFR rate of 4.46%. If the trust were to grow 8.0% annually, the grantor could shift \$484,029 to the trust beneficiaries at the end of the term. If the grantor did the same transaction when the mid-term AFR rate was 1.26%, the grantor could shift a value of \$722,524 to the trust beneficiaries. The lower AFR results in more potential to transfer wealth. This technique works well when a taxpayer has a significant estate (subject to estate taxes) and has an asset that generates enough cash flow to cover the payments on the note.

Mid-Term AFR	Annual Note Payment by Trust/Received by Seller	Gift Subject to Gift Tax	Projected Value at End of Term
4.46%	\$137,327	\$100,000	\$484,029
1.26%	\$118,228	\$100,000	\$722,524

Source: NumberCruncher.

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3. Qualified personal residence trust (QPRT)

A QPRT is an effective way to transfer the future appreciation of a personal residence out of the estate. A homeowner transfers their residence into an irrevocable trust, retaining the right to live in the residence for a certain number of years; afterward the residence passes to the beneficiary. The estate tax benefit comes from the fact that the gift tax value is reduced to the present value of the remainder interest. The remainder interest has an inverse relationship to interest rates, so as interest rates increase, the value of the remainder interest decreases (and thus lowers gift taxes).

Example:

Tom, age 75, puts his \$500,000 residence (which has been appreciating at a 4% rate) into a QPRT with a 10-year term. If the current IRS 7520 rate is 1.2%, the taxable gift to the beneficiary (typically a family member) would be valued at \$265,590. However, if the rates rise to 5.4%, the value of the gift drops to just \$176,855. With this technique, if the interest rate is higher, it results in the value of the grantor's retained right being higher and thus, less of a gift to the remainder beneficiaries, which makes it an effective wealth transfer strategy during periods of higher interest rates.

Section 7520 Rate	Taxable Gift (Present Value of Remainder Interest)	Property Value After 10 years	Potential Estate Tax Savings (Assuming a Combined Death Tax Bracket of 50%)
5.4%	\$176,855	\$740,122	\$281,634
1.20%	\$265,590	\$740,122	\$237,266

Note: This calculation is for illustrative purposes only. It assumes use of the 2010CM Actuarial table.

4. Intra-family loan

This simple technique involves a loan to a family member at the AFR. If the investment return exceeds the loan rate, the difference passes on to the borrower tax free. This strategy works best in a low-interest environment. If the rates are still low when the note matures, the lender and the borrower can refinance and continue with this strategy. However, the loan should be documented with a note, which could be interest-only with a balloon payment of principal at the end of the term.

Example:

Suppose a parent loaned a child \$1 million for 10 years at interest only and a balloon at the end. If the child invested it into an instrument yielding 7%, the current AFR would have a dramatic impact on the effectiveness of this technique. In April 2022, long-term monthly AFR was at 2.23%. That means the difference between the investment income of \$70,000 and annual interest payments of \$22,300 would, with compounding, end up with almost \$660,000 being transferred to the next generation tax free. If interest rates rose to 4.71% (March 2025 long-term monthly AFR) and all other assumptions remained the same, the amount transferred tax free to the next generation would drop to less than \$317,000, a decrease of more than 50%.

Mid-term AFR (Annual Compounding)	Interest Paid Annually	Balloon Payment (End of Year 9)	Net Amount Available to Child After Payment of the Loan
4.71%	\$47,100	\$1,000,000	\$317,000
2.23%	\$22,300	\$1,000,000	\$660,000

Source: NumberCruncher.

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Conclusion

There are many financial planning tools available to help you achieve whatever goal you may have, which can include providing an income stream, diversifying a portfolio, and satisfying charitable desires in a tax-efficient manner. As interest rates vary over time, so do the benefits of the various tools. For example, if you wanted to maximize the current tax deduction for a contribution to your charitable remainder trust, higher interest rates would benefit you. This chart summarizes the impact of interest rates on the various techniques discussed above.

	Lower Interest Rate Environment	Higher Interest Rate Environment	Why?
Grantor Retained Annuity Trusts (GRATs)	More Favorable	Less Favorable	Growth on asset > Section 7520 rate passes to beneficiaries.
Charitable Lead Annuity Trusts (CLATs)	More Favorable	Less Favorable	Higher possible income tax deduction in low-rate environment.
Intra-Family Loans	More Favorable	Less Favorable	Growth on investing borrowed funds outpaces interest payments.
Sale to an Intentionally Defective Grantor Trust (IDGT)	More Favorable	Less Favorable	Growth on asset > Section 7520 rate passes to beneficiaries.
Qualified Personal Residence Trusts	Less Favorable	More Favorable	Less taxable gift to remainderman. Potentially more estate tax savings.
Charitable Remainder Annuity Trust	Less Favorable	More Favorable	Higher rate, less gift to income beneficiary, higher amount to charity.
Charitable Gift Annuity	Less Favorable	More Favorable	Higher rate generally leads to a higher annuity payout and potentially larger charitable deductions.

Before choosing a strategy, it's essential to evaluate your overall goals and personal situation. Each strategy affects multiple parts of your financial life, so planning should never occur in a vacuum. A well-coordinated financial plan, revisited on a regular basis, helps ensure the desired goals are achieved and undesired surprises are avoided. Good planning also allows for modifications should your family situation change, as it often does.

For more information, please contact your advisor.

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About the Author

As a Senior Wealth Planner for Key Private Bank, Paul focuses on ensuring his clients' wealth management plans are carried through to meet their unique financial objectives and grow and preserve wealth.

Paul most recently served as a Regional Planning Strategist for Key Private Bank. Prior to joining Key, Paul was the director of Wealth Planning at Wilmington Trust and was responsible for the delivery of planning services and the planning platform including scalable advice-oriented solutions, thought leadership and direct planning where appropriate. Paul contributed to thought leadership and solutions to the Corporate Executive Practice Group, including direct planning for Corporate Executives. Prior to joining M&T Bank, which acquired Wilmington Trust in 2011, Paul was a tax manager with a CPA firm.

He holds an MBA from SUNY Buffalo and completed their Graduate Tax program. Paul is a Certified Public Accountant and a Chartered Global Management Accountant and has the Certified Financial Planner™, Personal Financial Specialist, Certified Life Underwriter, Retirement Income Certified Professional®, Certified Advisor in Philanthropy, Chartered Advisor in Senior Living, Chartered Financial Consultant and Certified Retirement Counselor designations. Paul instructed courses in the Certified Financial Planner Program as an adjunct faculty member of Canisius College in Buffalo, New York. He is currently the Treasurer and member of the Board of Directors for Muscalfare Theater in Amherst, New York. Previously he served on the Board of Directors and as the Treasurer of the Make-A-Wish Foundation of Western New York and BNSME. Paul is a member of the FPA, AICPA and NYSSCPA.



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