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HIGHER INTEREST RATES AND TAX EXEMPTIONS MAY MAXIMIZE BENEFITS IN GIFT AND ESTATE TAX PLANNING

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Lower business values driven by higher interest rates and higher tax exemptions included in the Tax Cuts and Jobs Act provide high-net-worth taxpayers with an opportunity to transfer assets without incurring a significant gift and estate tax liability.

Introduction

The Tax Cuts and Jobs Act of 2017 ("TCJA"), which went into effect January 1, 2018, implemented significant changes to the tax code for businesses and individuals.

For individuals, the TCJA doubled the gift and estate tax exemptions at the 2011 level, which was then adjusted annually for inflation. In the 2023 tax year, individuals can transfer up to $12.92 million, and a married couple can transfer a combined total of $25.84 million in assets (during the taxpayer's lifetime or as part of the taxpayer's estate) without triggering federal gift or estate taxes.

These provisions are set to expire on December 31, 2025, and the tax exemptions will be reduced by half if the U.S. Congress does not pass any intervening legislation.

In addition to the higher tax exemptions, the current environment of higher interest rates also benefits taxpayers who own significant assets. Spiraling inflation that began in 2021 in the United States caused the Federal Reserve (the "Fed") to raise interest rates to counteract the inflation. Higher interest rates generally affect business valuations by increasing the discount rate used to discount the future cash flow of a business. The higher the discount rate, the lower the present value of the cash flow and, thus, the lower the value of the business. As a result, a taxpayer potentially will incur a lower tax liability on the transfer of assets that are estimated at a lower value.

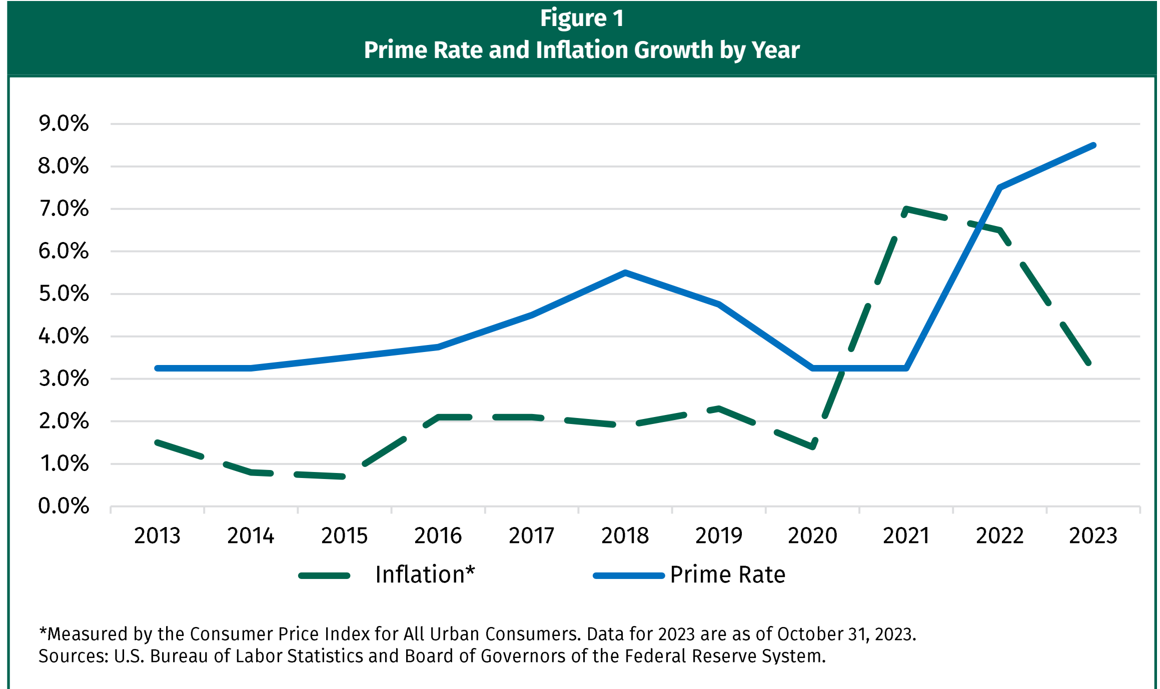
Taxpayers who own significant assets can benefit from the current environment of temporary higher interest rates. This article will discuss how higher interest rates can affect business valuations used for gift and estate tax purposes. Taxpayers who execute a gift and estate plan to transfer wealth to family members and friends can take advantage of lower business values and the higher gift and estate tax exemptions offered by the TCJA before they expire at the end of 2025.

The Impact of Inflation on Interest Rates

Since the Great Recession that began at the end of 2007, the United States enjoyed historically low inflation, as

measured by the consumer price index ("CPI"). However, the COVID-19 pandemic that began in early 2020 set the stage for inflation to spiral out of control.

Figure 1
Prime Rate and Inflation Growth by Year



*Measured by the Consumer Price Index for All Urban Consumers. Data for 2023 are as of October 31, 2023.
Sources: U.S. Bureau of Labor Statistics and Board of Governors of the Federal Reserve System.

The onset of the COVID-19 pandemic caused a severe economic downturn as governments issued "stay-at-home orders" or "lockdowns" to slow the spread of the virus. To stimulate the economy, the federal government increased the flow of money by offering stimulus funding to businesses and individuals. The Fed also kept interest rates low. Stuck at home with stimulus money, consumers responded by spending freely. In addition, the U.S. workforce shrunk as workers chose to stay home rather than return to work, which led to supply chain shortages worldwide. These events caused inflation to surge, beginning in 2021.

The Fed manages inflation by influencing the effective federal funds rate ("FFR"). The FFR is the average interest rate that banks pay for overnight borrowing in the federal funds market. The Fed uses certain tools to adjust the FFR because it influences other interest rates. The two tools used to keep the FFR in the target rate range are:

1. Interest on reserve balances ("IORB"): The Fed pays interest on the reserves that banks keep with it.

2. Overnight reverse repurchases ("ON RRP"): The Fed sells securities to banks that are not eligible to earn interest on reserve balances. The Fed then repurchases the securities at a higher price the following day, essentially paying the bank interest.

The Federal Open Market Committee sets a target range for the FFR and then sets the IORB and ON RRP rates to manage the effective FFR. In turn, banks charge each other interest on loans that reflect these changes.[1] Since March 2022, the Fed has increased the FFR 11 times, to a range of 5.25–5.5 percent in the ongoing effort to tame inflation. The FFR was zero–0.25 percent in January 2022.

The FFR has a significant impact on the prime rate, the interest rate that banks charge their best customers. The prime rate affects consumer interest rates, including those for deposits, bank loans, credit cards, and adjustable-rate mortgages.

As presented in Figure 1, inflation (measured by the CPI for urban consumers) increased significantly from 1.4 percent at calendar year-end 2020 to 7.0 percent at calendar year-end 2021. Even as inflation increased, the Fed kept interest rates low based on the expectation that the spike would be temporary. Finally, in 2022, the Fed began to raise the FFR to curb inflation, causing the prime rate to increase from 3.25 percent in December 2021 to 7.5 percent in December 2022 and 8.5 percent in October 2023.

Inflation may decrease company valuations by (1) increasing operating costs, leading to lower profits; and (2) changing how investors value those profits. Inflation affects the value that investors place on a company's

profits by amplifying risk and making a company's cost of capital more expensive through the higher interest rates that result from inflation. As interest rates and uncertainty increase, investors demand higher rates of return for the same level of cash flow, which, all else being equal, will drive down a business valuation.[2]

Inflation began to moderate in June 2023. Over the 12 months through October 2023, the CPI increased only 3.2 percent before seasonal adjustment. Consequently, as of December 2023, the Fed has not increased interest rates further. The Fed's target inflation rate is 2 percent. If inflation continues to decline, the Fed plans to cut interest rates in 2024.

The Effect of Rising Interest Rates on Business Values

When valuing a business, there are three generally accepted valuation approaches to consider: (1) the income approach, (2) the market approach, and (3) the asset-based approach. This article will focus on how higher interest rates can impact business valuations using the income and market approaches.

Market approach methods rely on the premise that prices of securities of companies in the same or similar lines of business as the subject company provide informational value to investors. The value of the subject company is measured through an analysis of recent sales or offerings of a comparable asset.

The income approach explicitly recognizes that the value of an investment is premised on the expected receipt of future economic benefits. Value indications are developed by discounting (or capitalizing) the expected net cash flow of a company to a present value at a discount rate that reflects the estimated risk associated with the expected realization of the projected cash flow.

In income approach methods, the discount rate plays a critical role in determining a company's value. "The discount rate represents the rate of return that an investor requires to justify his or her investment in an asset, depending on the amount of risk associated with the investment ... Discount rates are determined by the market. Discount rates take into consideration the inflationary expectations of the future benefit stream being used."[3] Rising interest rates can increase the discount rate, which would result in a lower present value of future cash flow.

One of the basic components of estimating the discount rate is the risk-free rate of return. The risk-free rate is the rate of return on a risk-free investment, such as U.S. Treasury investments. Most valuation analysts use the 20-year U.S. Treasury bond as the risk-free component for estimating the cost of equity capital to reflect the investment horizon of the investment (i.e., the subject company) and longer-term inflation expectations. According to the Federal Reserve Statistical Release, the market yield on the 20-year U.S. Treasury bond increased from 1.9 percent on December 31, 2021, to 4.1 percent on December 31, 2022.

Interest rates and the risk-free rate typically increase in tandem. All else being equal, when the risk-free rate increases, the cost of capital will increase, particularly the cost of equity ("COE"), because investors will demand a higher rate of return to compensate for the increased risk. The COE is the appropriate discount rate to use in a valuation based on the net cash flow available to equity stakeholders. Due to the increase in the market yield on the 20-year U.S. Treasury bond since 2021, the COE of companies generally increased by two percentage points.

The following table illustrates how a two-percentage-point increase in the risk-free rate can affect a company's value. As shown, a higher discount rate (i.e., the COE) reduces the business value because the income stream (i.e., cash flow) of the company is capitalized using a higher capitalization rate.

Table 1
Effect of Rising Interest Rates on Business Values

	Example 1	Example 2
Risk-Free Rate	2.00%	4.00%
Cost of Equity	12.0%	14.0%
Long-Term Growth Rate	3.0%	3.0%
Capitalization Rate [a]	9.0%	11.0%
Implied Valuation Multiple [b]	11.1	9.1
Cash Flow	$1,000,000	$1,000,000
Indicated Business Value (rounded) [c]	$11,111,000	$9,091,000

[a] COE less the long-term growth rate.
[b] Represents the inverse of the capitalization rate.
[c] Cash flow (economic benefit) divided by the capitalization rate.

Rising interest rates also affect the market multiples applied in the market approach methods. A multiple is another form of a capitalization rate. Mathematically, a multiple is the inverse of a capitalization rate (e.g., a capitalization rate of 9.0 percent equals a multiple of 11.1x, or 1 divided by 9 percent [0.09]).

As illustrated above, a higher capitalization rate, driven by rising inflation and a higher risk-free rate, translates into a lower earnings multiple. Rising interest rates entice investors to shift investment to fixed-income assets that deliver higher yields, and the overall stock market may experience a decline, thereby lowering market multiples.

Similarly, increasing cost of capital caused by rising interest rates may deter investors from paying a price premium for target companies or adopt more conservative acquisition strategies to account for the increased opportunity cost. This would lower the implied multiples of transactions of merged and acquired companies and lower company valuation.

Conclusion

The current environment of higher interest rates may lower business valuations by increasing a company's discount rate and lowering market multiples. Lower business values combined with higher exemptions for gift and estate tax transactions may provide benefits for taxpayers who own significant assets.

The following example illustrates the potential tax savings from higher interest rates and higher tax exemptions. A taxpayer owns 100 percent of Company XYZ. Company XYZ's value was estimated two years prior at $20 million, but higher interest rates (and a higher discount rate) reduced the business value to $12 million currently.

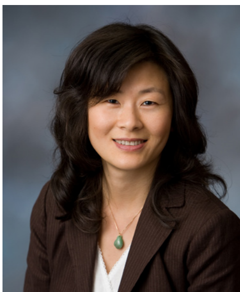
Since an individual can transfer up to $12.92 million in assets in the 2023 tax year without triggering federal gift or estate taxes, the taxpayer's transfer of assets based on Company XYZ's current value of $12 million would not trigger any federal gift or estate taxes.

If the taxpayer transferred assets based on Company XYZ's value of $20 million two years earlier, the taxpayer could potentially owe a tax liability on over $7 million in value (i.e., $20 million less $12.92 million).

Now let us assume the higher tax exemptions expire at the end of 2025 and the tax exemption is reduced by half (i.e., $6.46 million), along with lower interest rates. If the taxpayer then transfers assets based on Company XYZ's value of $20 million, the taxpayer could potentially owe a tax liability on over $13 million (i.e., $20 million less $6.46 million).

So, it may be prudent for taxpayers to execute a gift and estate plan before interest rates return to lower levels and the favorable provisions in the TCJA potentially expire at the end of 2025.

About the Author



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