Jefferies

QPRTs Add Value During Higher Interest Rate Environments

WEALTH PLANNING

JULY 25, 2024

Alan Wolberg | Managing Director, Financial Planner

Low interest rates which existed during the height of the COVID pandemic have gone the way of the dinosaur for now – while not extinct, they are not likely to return in the short term. Since the pandemic, rising interest rates have made Grantor Retained Annuity Trusts (GRATs) a less favored planning strategy. Instead, Qualified Personal Residence Trusts (QPRTs) have now gained traction as an effective estate planning tool for ultra-high net worth individuals and families.

How does a QPRT Add Value?

A QPRT is a specific type of irrevocable trust that allows a homeowner to transfer property out of an estate, to beneficiaries, at a discounted value. Thereby minimizing future gift and estate taxes.

By transferring a primary residence or a vacation home (or even a fractional share of the property) to a QPRT, you achieve the following:

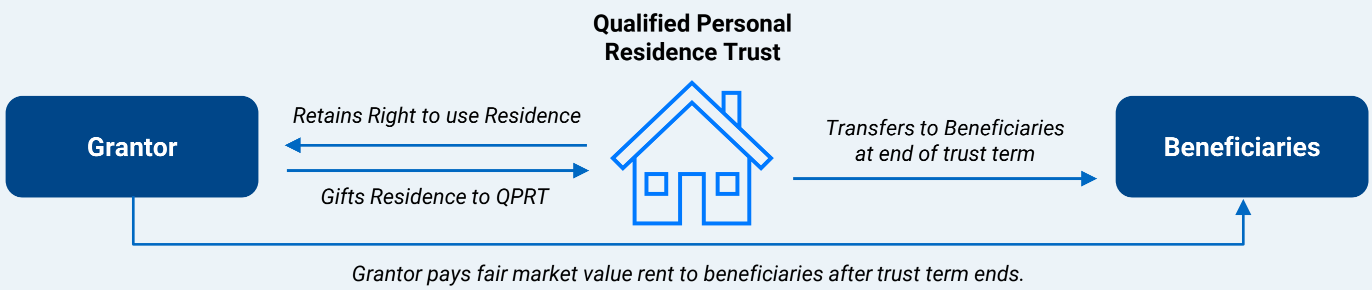
- The original owner retains the right to live in the property during the trust term
- The value of the retained interest reduces the gift value since the trust's beneficiaries must wait for the trust term to end to receive the benefit
- The value of the trust transfers irrevocably to the beneficiaries, free of any additional gift or estate tax, when the trust terminates
- If the grantor wishes to remain living on the property at the end of the trust term, they can do so by paying Fair Market Value (FMV) rent which serves as an additional source of cash flow to beneficiaries
- The estate tax savings resulting from removing the residence and any future appreciation on the residence from the estate should outweigh potential capital gains tax if the residence is sold

These benefits make QPRTs a very effective way for an estate to transfer a highly valued appreciating asset (a residence) at a minimal transfer tax cost.

Why Now? Higher Interest Rates Lower the Taxable Gift Value

QPRTs directly benefit from an increase in interest rates, setting them apart from other wealth transfer strategies, like GRATs. This is because federal tax laws rely on the

HOW A QPRT WORKS



For illustrative purposes only. Does not constitute endorsement of wealth transfer strategy.

Section 7520 rate to calculate the value of the grantor's retained interest in the transferred property. The Section 7520 rate is equal to 120% of the applicable federal mid-term rate as set forth under Section 7872 of the Internal Revenue Code (IRC).

The higher the 7520 rate, the greater the value assigned to the grantor's retained interest in the property, which decreases the value of the trust's remainder interest, resulting in a lower gift value to beneficiaries.

Potential Drawbacks of a QPRT

As with any wealth planning strategy, there are potential drawbacks to establishing a QPRT.

- If the grantor dies before the term ends, the entire property value reverts to the estate for tax purposes
- Once the QPRT term expires, the home no longer belongs to grantor and grantor must pay the beneficiaries FMV rent so that the IRS will consider the gift to be complete
- Rent paid after the QPRT term is considered taxable income to the beneficiaries
- Gifting a highly appreciated residence through a QPRT means forgoing a step-up in cost basis on the home at the grantor's death – potentially increasing the capital gains tax due upon the sale of the home
- Transferring a home into a QPRT is considered a change in ownership and may trigger a reassessment of the property value for state and local property taxes[1]
- If the property is mortgaged, the value of the gift is determined by the equity the grantor has in the home, with each mortgage payment considered a new contribution (gift) to the trust
  - These "gifts" count against the estate's lifetime gifting exclusion amount/annual exclusion gifting amount[2] and may result in a gift tax

Next Steps. Assess the Value of a QPRT for Your Estate

QPRTs can be an attractive way to transfer an estate's primary residence or vacation home to beneficiaries while minimizing wealth transfer taxes, especially when interest rates are high or on the rise. Although there are no age restrictions -- given the term length of a QPRT, it is most suitable for grantors who are in their mid-50s to early 60s. It is also important to weigh the pros and cons of establishing a QPRT based on your specific situation before making any decisions. To help decide if a QPRT is right for you please speak to your Jefferies Wealth Advisor or tax/estate planning specialist.

A CASE STUDY

Higher Rates Benefit an Estate

Elaine is 60 years old. Her home is currently worth $3 million. Elaine plans to transfer her home to her children by establishing a QPRT with a 10-year term -- using a portion of her lifetime applicable gift tax exclusion amount.

- In February 2021, at a 0.6% 7520 rate, her retained interest would have been $0.6 million, with a $2.4 million taxable gift.
- By waiting until February 2024, when the 7520 rate rose to 4.8%, her retained interest increased to $1.4 million, reducing the taxable gift to $1.6 million—a 33% decrease in her lifetime gift tax exclusion amount.

But Be Aware of Timeframes

In Elaine's case, lengthening the term of her QPRT from 10 years to 15 years decreases the amount of her taxable gift to $1.2 million (a difference of $500K (see Chart 2). However, she must carefully weigh the benefits of making a smaller gift against the increased risk of not completing the transfer.

CHART 1 | Higher Interest Rates Result in Lower Gift Tax Implications[3]

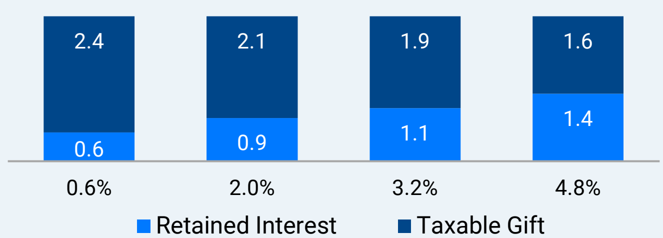


CHART 2 | Longer QPRT Terms Decrease Taxable Gift but Increase Mortality Risk[4]

1. Reassessment only applicable in a handful of states. Increase in property taxes typically outweighed by estate tax savings
2. As of tax-year 2024, Lifetime Gifting Exclusion amount is equal to $13,610,000; Annual Gifting Exclusion amount is equal to $18,000.
3. Assumes a 60-year-old individual funds a QPRT with a $3 million primary home. QPRT is for 10-year term. Retained interest and taxable amounts are calculated based on a Section 7520 rate of 0.6%, 2%, 3.2% and 4.8%
4. Assumes a 60 year-old individual funds a QPRT with a $3 million primary home when the Section 7520 rate is 4.8%. Retained interest and taxable gift amounts are calculated based on a term of 5 years, 10 years, 15 years or 20 years.

Jefferies

Important Disclosures

This presentation is for informational purposes only and is not intended as an offer or solicitation for the sale of any financial product or service or as a determination that any investment strategy is suitable for a specific investor. The tax information contained herein is general in nature, procured directly from the IRS website (https://www.irs.gov/), provided for informational purposes only, and should not be construed as legal or tax advice. Jefferies LLC does not provide legal or tax advice. Laws of a particular state or laws which may be applicable to a particular situation may have an impact on the applicability, accuracy, or completeness of such information. Federal and state laws and regulations are complex and are subject to change. Changes in such laws and regulations may have a material impact on pre- and/or after-tax investment results. Jefferies LLC makes no warranties with regard to such information or results obtained by its use. Jefferies LLC disclaims any liability arising out of your use of, or any tax position taken in reliance on, such information. Always consult an attorney or tax professional regarding your specific legal or tax situation.

Investors should seek financial advice regarding the suitability of any investment strategy based on their objectives, financial situations, and particular needs.

This presentation is not designed or intended to provide financial, tax, legal, accounting, or other professional advice since such advice always requires consideration of individual circumstances. Opinions or estimates constitute our best judgment at this time and are subject to change without notice. Information upon which this brochure is based was obtained from sources believed to be reliable but has not been verified.

All information contained herein is intended solely for your own personal, informational use, and you are not permitted to reproduce, retransmit, disseminate, sell, license, distribute, republish, broadcast, post, circulate or commercially exploit the information in any manner or media without the express written consent of Jefferies, or to use the information for any unlawful purpose.

Investment Advisory services are offered through Jefferies Investment Advisers LLC, an SEC Registered Investment Adviser, and wholly owned subsidiary of Jefferies Financial Group Inc. Jefferies LLC is an SEC-registered broker dealer, a CFTC-registered futures commission merchant and a member of FINRA/SIPC and NFA.