Using a "Split Purchase QPRT" Can Achieve Transfer Tax Savings and Other Benefits Unavailable With Other Strategies

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Until the estate and gift tax laws changed in 1991, estate planners used a technique known as a "split purchase" to achieve estate tax reduction benefits for their clients who are considering purchasing an asset but who wish eventually to transfer it to their children with the least possible estate tax cost. The "split" in the term "split purchase" refers to the consecutive property interests purchased by the parents and the children. The parents' portion of the split involves their purchase of a "life interest" in the property for a price determined under actuarial tables published by the Treasury Department. The children's portion of the split is their purchase of the "remainder interest" -- the property interest remaining after the parents' deaths and the termination of the parents' joint life interest. In the case of a split purchase of a residence, the parents would pay for their life estate, and that payment would entitle them to the rent-free use and occupancy of the property during their joint lives. The children would receive the residence outright upon the death of the surviving parent without having the residence included in the surviving spouse's "gross estate" or otherwise subject to estate taxation as it passes to the children.

This could produce estate and gift tax savings because the amounts paid by the parents and children for their respective interests would be based on the value of the property on the date of the purchase. The strategy worked especially well for properties which were expected to appreciate significantly because the floating discount rate used to determine the present value of the children's future interests is based on a market interest rate -- an external benchmark which bears no relation to the actual appreciation enjoyed by the split purchased asset. The family "wins" to the extent that the asset outperforms the "hurdle" rate.

If, for example, the split purchase occurred in July, 1999, when the discount rate was 7%, and the split purchased property were to appreciate at a rate greater than the discount rate, the parents would have overpaid for their income interests, and the children will have underpaid for their remainder interests, resulting in a transfer tax-free shift of value from the parents to the children. The strategy stands the best chance of success in a low interest rate environment (in March, 2007, for example, was 5.8% -- a full hundred and twenty basis points lower than the rate quoted earlier for July, 1999).

Such tax-free value shifting also would occur if the parents died before their joint actuarial life expectancy period assumed in the Treasury's actuarial tables. If in our example the tables assume a joint life expectancy for the parents of 15 years, and the surviving parent dies in the 10th year following the split purchase, transfer tax-free wealth accrues to the children because the parents would have overpaid for their life interest. By contrast, parents who survive the actuarial period, requiring their children to wait longer for the vesting of their remainder interest, can be whipsawed by the strategy purely from an estate tax perspective. Although it sounds perverse, for this reason the split purchase will work optimally where the client's health status is uncertain, creating a real possibility that the client

will not live a "normal" life expectancy. The Treasury Regulations allow the use of the actuarial tables irrespective of the client's health as long as the client is not suffering from a terminal illness under circumstances creating a 50% or better chance that the client will not survive for a period of one year following the valuation date.

This was a very popular technique until Congress enacted legislation in 1991 severely restricting the use of split purchase and another transfer tax "value-freezing" strategies. The new rules accomplish this by recasting a split purchase transaction as an immediate gift from the parent to the children in an amount equal to the actuarial value of the parent's life estate. The application of the new rules completely eliminates any value freezing and wealth-shifting benefits the strategy previously offered.

We believe, however, that the 1991 rules create an exception to the general rule for split purchases of personal residences accomplished through a qualified personal residence trust, or "QPRT". In enacting the new legislation, Congress was particularly concerned with overreaching taxpayers who split purchased high income producing and/or rapidly appreciating financial investments which, through taxpayer engineering, were virtually guaranteed to produce annual total returns which greatly exceeded the discount rates in the valuation tables, thereby artificially creating tremendous tax-free wealth shifting benefits. Congress perceived no such potential for abuse with personal residences where the values cannot be manipulated and which produce no income and can be expected to appreciate at a relatively modest rate.

Note that the extent of the exception for split purchases of residences is somewhat unclear under the applicable provisions of the Internal Revenue Code and the Treasury Regulations which interpret and apply them. Many commentators, however, feel that a direct split purchase by parent and children (or an existing irrevocable trust of which the children are beneficiaries – preferably a "generation-skipping trust") may fall outside the exception, and that a split purchase effected through a QPRT will pass muster. An IRS private ruling published last year provides additional comfort for that proposition.

A QPRT split purchase would work as follows:

- The client or clients would first execute the QPRT document itself. Married clients may choose to execute a joint QPRT. The choice between a joint and single settlor QPRT depends upon how the client evaluates the pluses and minuses of each. A joint trust requires the least possible investment from the children (or irrevocable trust) but also, because of its potentially long duration, creates the greatest possible risk of loss of estate tax benefits -- particularly if one or both of the clients outlive their joint life expectancy period and/or the property fails to appreciate at a rate greater than the §7520 discount rate. The joint trust alternative trust also guarantees the client the rent-free use of the residence for their lives. Using a trust created and funded only by one spouse based on his or her single life expectancy requires a greater contribution by the children (or trust) and increases the potential estate tax benefits (particularly if the clients have reason to believe that one of them might have a shorter than normal life expectancy), but creates the prospect of the non-grantor surviving spouse having no guaranteed right of rent-free use of the property after the settlor spouse's death unless the

surviving spouse is a beneficiary of the irrevocable trust holding the remainder interest and after his or her spouse's death can use the property rent-free without any estate tax risk.

- Once the clients sign the trust (assuming it is a joint split purchase QPRT), the settlors and their children (or trust) will contribute their respective shares of the purchase price. The clients or another person they designate as trustees of the split purchase QPRT would then enter into the Purchase and Sale Agreement ("P&S") with the seller. It is important that the P&S schedule a closing within three months of the date of the creation and funding of the split purchase QPRT, with time being made of the essence under the terms of the P&S.

- The trustee of the split purchase QPRT will then close the purchase as the buyer. The clients, as life tenants, will be responsible to directly pay (i.e., outside the trust) all carrying charges such as maintenance, repairs, property taxes, homeowner's insurance premiums, utilities, etc., throughout their joint lives. They should be careful, however, in making any expensive capital improvements to the property. Any such improvements must be financed by proportionate contributions made by the clients, as life tenants, and the children (or irrevocable trust), as remainder beneficiary, based on actuarial calculations to be performed on the date the improvements are to be made.