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White Paper

Estate Freeze Technique:

Split Interest Purchase

www.selectportfolio.com • Toll Free 800.445.9822 • Tel 949.975.7900 • Fax 949.900.8181

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Estate Freeze Technique: *Split Interest Purchase*

What is it?

A split interest purchase of property is a transaction where two or more parties agree to split the purchase of a piece of property with each party purchasing a consecutive interest. This method can increase your income without increasing your taxable estate. One or more parties purchases either a life interest or a term interest in the property. A life interest gives the holder the right either to receive income for life from the property or to use, enjoy, and possess the property for life. A term interest gives the purchaser the right to receive income from or to use the property for a specified term. Upon the death of the holder of the life or term interest or when the specified term ends, the holder of the remainder interest becomes the owner of the property.

Each person who is a party to the split interest purchase pays his or her share of the actuarial value of the property purchased. The parties must use government valuation tables to determine the value of the separate interests.

A split interest purchase, if structured properly, can be an effective estate freezing technique because the value of the property is not included in the estate of the life or term holder. Any appreciation in the underlying asset passes to the holder of the remainder interest free of transfer tax.

When can it be used?

Both parties to split interest purchase must pay actuarial share of purchase price

To make a split interest purchase work for gift and estate tax purposes, all parties must pay their actuarial share of the purchase price. The price that each party pays for his or her interest is based on actuarial and valuation tables issued by the IRS. It is critically important that the party purchasing the life or term interest does not furnish money for any part of the purchase of the remainder interest.

Ownership of property must be split into two parts

Ownership of the property or asset that is the subject of a split interest purchase must be split into at least two parts--a life or term interest and a remainder interest. The life or term interest consists of either the right to receive payments or the right to use the property for life or for the specified term. The remainder interest is the right to the property on the death of the life interest holder or upon the end of the specified term.

Example(s): Hal and his daughter, Liz, would like to purchase an apartment building on a split interest basis. Hal purchases a life interest in the income from the building and receives all the income generated from the building for as long as he lives. Hal pays an amount equal to the present value of the stream of payments to be received based on the government actuarial and valuation tables. Liz then purchases the remainder interest. Upon the death of her father, Liz becomes the owner of the building. The value of the building is not included in Hal's estate upon his death. However, if Hal's interest is not a qualified interest for purposes of Section 2702, there may be gift tax consequences to this transaction.

Purchaser of life or term interest may receive annuity or unitrust payments

A split interest may also be structured so that the purchaser of the life or term interest receives a stream of fixed annuity payments or percentage payments (called unitrust payments) based on an annual valuation of the underlying asset. The purchaser pays an amount that is equal to the present value of the annuity or unitrust payments.

The parties to a split interest purchase own consecutive interests

In a split interest purchase, both the purchaser of the life or term interest and the purchaser of the remainder interest own the property, although their interests are consecutive and not concurrent. Therefore, the property generally cannot be sold in fee simple without the consent of both parties.

Various types of property may be used in a split interest purchase

In most cases, the property that is the subject of a split interest purchase will be an asset that generates income. However, tangible or other property that does not generate income (e.g., artwork, undeveloped real estate, etc.) may also be used. In this case, the purchaser of the life or term interest will have the right to use, possess, and enjoy the asset rather than the right to enjoy income from it.

Example(s): The life or term holder may purchase the right to display the artwork in his or her house for the remainder of his or her lifetime or may purchase the right to use non-income-producing beachfront property for the next 10 years, until he or she retires to Florida. In the case of tangible or non-income-producing property, the life or term interest must be capable of being valued, otherwise the parties will run into Section 2702 problems.

Strengths

Split interest purchase may be an effective strategy to increase income

A split interest purchase is a very good strategy if you would like to increase your current income. If you purchase a life or term interest in an income-producing property, your return will be increased by the purchase of the remainder interest by the other party.

Example(s): You are 65 years old and ready to retire. You would like some additional income. You own a substantial portfolio of growth stocks that pay a very small dividend. You also have other substantial non-income-producing assets. You have a 35-year-old son. One strategy to increase your current income without increasing the value of your estate is to set up a split interest purchase of income-producing property with your son. The transaction can be structured so that you purchase an income interest in the property (in the form of qualified annuity payments for life), and your son purchases the remainder interest. Your return in the asset is increased over what it would be if you simply purchased the property outright because your son has contributed in part toward the total purchase price (through the purchase of the remainder interest). In a sense, your investment has been leveraged through the split interest purchase. One other benefit is that the value of the asset purchased is not included in your taxable estate.

Note that it is important to structure the purchase to comply with the requirements of Section 2702 of the Internal Revenue Code because your son is a member of your family and you have retained a term interest in the property. If your life or term interest is not a qualified interest, then you will be considered to have made a gift to your son of the fair market value of the property less the actual amount paid by your son for his remainder interest.

Split interest purchase may avoid will contest

Because a split interest purchase is a contractual agreement, the property that is the subject of the split interest purchase is not part of your probate estate. Upon the death of the purchaser of the life interest or at the end of the specified term, the property passes by operation of law outside of probate directly to the purchaser of the remainder interest. There are several benefits to having the asset pass outside of probate. First, it avoids having any disgruntled heirs challenge the disposition of the asset. Second, a split interest purchase protects the privacy of the parties by avoiding the public probate process. Third, it may provide some protection against creditors.

Split interest purchase should keep asset out of taxable estate

If structured properly, an asset that is the subject of a split interest purchase will not be included in the taxable estate of the life or term holder.

Example(s): You purchase a qualified annuity interest for life in income-producing property. Your daughter purchases the remainder interest. You paid the full actuarial value of your life interest. Upon your death, the value of the property is not included in your taxable estate because the property passed to your daughter immediately upon your death by operation of law.

Tradeoffs

Split interest purchase may not work when gift taxes are major consideration

A split interest purchase of property may not always be the best strategy if you have fully utilized your \$1 million gift tax applicable exclusion amount (formerly known as the unified credit) or expect to in the future. It also may not be the best strategy if payment of gift taxes could be a major problem for you. Under Section 2702 of the Internal Revenue Code, joint purchases of property are treated as transfers in trust. Section 2702 is extremely complicated, but, under certain circumstances, this transfer is considered a taxable gift to the remainder holder equal to the total value of the property less the consideration paid by the remainder holder for his or her interest in the property (i.e., the amount that the life or term holder paid for his or her interest). Therefore, a gift tax may be incurred on a split interest purchase. The imposition of this tax has severely curtailed the use of split interest purchases.

Permission from both term holder and remainder holder are needed to sell property

The term holder and the remainder holder own consecutive interests in the property. The property, therefore, cannot be sold in fee simple without the consent of both parties.

How to do it

Hire competent, experienced attorney to draft documents

Setting up a split interest purchase can be extremely complicated. You should hire an attorney well versed in this type of transaction. There are many technical and specific requirements you need to follow to avoid gift and estate tax liability. Section 2702 of the Internal Revenue Code requires you to jump through many hoops to make a split interest purchase work.

Actuary may be needed to calculate purchase price for term and remainder interest

Both the life or term holder and the remainderperson must pay their proportionate share of the purchase price based on applicable government valuation and interest rate tables. An actuary or an accountant can calculate the amount that each person will have to pay. An actuary is an individual who is educated and trained to calculate present value amounts and other complex valuations. If you cannot locate one through the local yellow pages, then your attorney or accountant may be able to refer one to you.

Life holder and remainder person must agree on property to be purchased

Because the life or term holder and the remainder holder own successive interests in the property, both parties should agree on the type of property that will be used for the split interest. Typically, the

property is an asset that will produce income for the life or term holder and will appreciate for the remainder holder. In rare cases, an asset that does not produce income (e.g., artwork, undeveloped land, etc.) may be used. In this case, the life or term holder will use, possess, and enjoy the property for life or the specified term, and the remainder holder will become the owner of the property upon the death of the life holder or at the end of the term.

Caution: To avoid gift tax liability, the parties to the split interest must show that each party paid fair market value for his or her share, which may involve obtaining comparable rental values for non-income-producing properties. This may be very difficult for such objects as art or undeveloped real estate.

Tax considerations

Income Tax

Life or term holder may owe taxes on income received from property

The life or term holder may be subject to income taxes on any income received from the property. You should consult with your tax advisor to determine if a split interest purchase may cause you adverse income tax consequences.

Gift Tax

Split interest purchase may have adverse gift tax result

A split interest purchase may have adverse gift tax consequences for the purchaser of the life or term interest. Under Section 2702 of the Internal Revenue Code, joint purchases of property are treated as transfers in trust. If the split purchase is between family members of two different generations and the life or term interest is not a qualified interest, the purchaser of the life or term interest is considered to have acquired the entire property and then to have transferred the remainder interest in exchange for any consideration given. For gift tax purposes, the income interest is then valued at zero. The life or term holder is considered to have made a gift to the remainder person of the fair market value of the property less the actual amount paid by the remainder person for his or her remainder interest. For gift tax purposes, the gift amount is limited to the consideration paid by the life or term holder for his or her interest.

Example(s): You and your 40-year-old daughter decide to enter into a split interest purchase on an apartment building. The apartment building has a fair market value of \$300,000. Based on actuarial assumptions, you pay \$120,000 for a life interest in the income from the building and your daughter pays the balance of \$180,000 for the remainder interest. Under Section 2702, if your life interest is not a qualified interest, you are considered to have acquired the entire property and to have made a gift of the entire property to your daughter. For gift tax purposes, the value of the gift is limited to the \$120,000 you paid for your life interest (e.g. the total value

of the property less the consideration of \$180,000 paid by your daughter). If your unified credit is not available to apply to the gift, you may owe a gift tax on this amount. It is the imposition of this gift tax in certain situations that has decreased the popularity of the split interest purchase as an estate freezing tool.

Gift tax not imposed if life or term holder retains qualified annuity or unitrust payments

If you, the life or term holder, elect to receive fixed annuity payments or unitrust payments (these are annual payments from a charitable remainder that are based on a fixed percentage of the trust's asset value) and you pay an amount equal to the present value of such annuity or unitrust payments for such interest so that it is "qualified" under Section 2702, there is no taxable gift. The present value of the annuity or unitrust payments and the consideration paid by the remainder person must equal the total value of the property purchased in the split interest transaction. Since the taxable gift in this situation is determined by subtracting the value of all qualified interests and the consideration paid by the remainder person from the total value of the property, structuring the transaction this way should leave nothing to which the gift tax can be applied. No gift tax is therefore imposed.

Caution: This is an extremely technical area. Section 2702 is very complicated. Before trying to set up a split interest purchase, you should consult an attorney experienced and knowledgeable in this area. Failure to follow all the requirements of Section 2702 could result in a substantial gift tax liability.

Benefit of split interest purchase may still apply to certain tangible property

A split interest purchase of certain tangible property, if structured properly, still retains gift and estate tax benefits. The life or term interest in certain tangible property such as artwork or undeveloped real estate is not valued at zero. Instead, the regulations under Section 2702 allow you to value the property at an amount that a willing buyer would pay a willing seller for it. Unfortunately, the burden is on you to prove what the interest in the property is worth to a willing buyer. This may be a very difficult task. The value of the life or term interest for these purposes is best established through actual sale or rental of comparable property. If you cannot prove what the value to a hypothetical "willing buyer" would be, the retained interest is valued at zero and you have all the estate and gift tax problems discussed above. However, once you prove the property's value to a willing buyer, then you can value your life or term interest at this amount (and not at zero as otherwise required under Section 2702). Thus, a split interest purchase in tangible property may allow you to use the property for life (or a certain term) and then have the remainder pass to another person upon your death or at the end of a specified term without suffering gift tax consequences.

Caution: This is an extremely technical area. You should consult a competent attorney experienced in this area.

Estate Tax

Split interest purchase should have no estate tax consequences

If a split interest purchase is structured and implemented so that the life or term holder pays the full present value of either the annuity or unitrust payments (or of the use of tangible property), then the property that is the subject of the split interest purchase should not be taxable in the life or term holder's estate. Because the property passes to the remainder holder by operation of law prior to or immediately upon the life or term holder's death, there is nothing to be included in the estate.

Questions & Answers

Why would you want to enter into a split interest purchase when you could simply buy the asset outright?

If structured properly, a split interest purchase can be an effective estate freezing technique for unrelated or remotely related parties. With an outright purchase, the value of the asset (including any appreciation in the asset) is included in the taxable estate of the purchaser providing it is not disposed of during the purchaser's lifetime. With a split interest purchase, the value of the asset (and any associated appreciation) is not included in the estate of the purchaser for estate tax purposes. A split interest purchase can therefore be an excellent way to enjoy the benefit of an asset for life or for a specified term of years without risking inclusion of the value of the asset in your taxable estate.

Has Section 2702 limited the usefulness of a split interest purchase?

Yes. Unfortunately, the enactment of Section 2702 has limited the use of a split interest purchase for estate freezing purposes. As explained in the tax section above, Section 2702 treats the traditional form of split interest purchase (interests split between family members of different generations) as a taxable gift from the purchaser of the life or term interest to the purchaser of the remainder interest. The amount of the gift is the difference between the total value of the property and the amount paid by the remainder person (i.e., the gift is the amount paid by the life or term holder). Therefore, with a traditional split interest purchase, the life or term holder may have to pay a gift tax. The possibility of incurring gift tax has discouraged many people from engaging in this type of transaction.

Is there a way to structure a split interest gift so that the gift tax will not apply?

Yes. You can structure a split interest purchase so that Section 2702 will not apply and so that you will not incur a gift tax. One way is that instead of retaining the income from the property for life or for the specified term, you receive qualified annuity or unitrust payments based on an annual valuation of the property. If the consideration you pay for the annuity or unitrust payments (e.g. the amount you paid for your interest in the property) is equal to the present value of those payments (on an actuarial basis), then there is no taxable gift on the remainder interest. Section 2702 is extremely complicated. You should consult an experienced and competent attorney before setting up a split interest purchase.

What type of property should be used in a split interest purchase?

In most cases, the property that is used in a split interest purchase is income-producing property. You will generally elect to receive income from the property for either your lifetime or for a specified term of years. Non-income producing property (e.g., artwork, undeveloped real estate, etc.) can be the subject of a split interest purchase; however, such a purchase may be subject to the gift tax unless you can show what the fair market rental would be for that asset. This may be very difficult for an asset like artwork.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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