Private Annuity

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A. Defined: Transfer of property in exchange for unsecured promise to make fixed payments over the lifetime of the transferor.

B. Typical Situation: Sale of appreciated property, such as a business or investment real estate, in exchange for monthly or annual payments of a fixed dollar amount for life. For wealth transfer purposes, if anticipated that transferor will not live out his or her life expectancy, allows for, among other things, transfer of asset at a discount, and reduction in amount of capital gains tax payable in connection with sale.

C. Advantages:

1. Estate Tax Savings. Removes the transferred property and all future appreciation from the estate without use of gift or estate tax exemptions. Valuation discounts for minority interests and lack of marketability also available.

2. Income Tax Deferral/Dodge. Where appreciated property is sold, the seller defers recognition of gain until receipt of annuity payments. (Each payment consists of tax free return of basis, capital gain and ordinary income)

3. Maintains Family Wealth. Maintains wealth within the family.

4. Estate Liquidity. Converts an illiquid asset into monthly payments.

5. Retirement. Provides a stream of income for retirement.

6. Probate Avoidance. Avoids probate.

7. Asset Protection. A private annuity may place the transferred property beyond the reach of potential creditors and litigants if the transferor retains no interest in the transferred property.

8. Diversification. Private annuity payments allow the transferor the opportunity to diversify their portfolios.

D. Disadvantages

1. Investment Risk. Property transferred declines in value or yields less than the amount of the annuity, thereby increasing the estate.

2. Possible Lower Income Tax Basis if Asset is Retained at Transferor's Death. Upon a sale of the asset by the transferee during the lifetime of the transferor, the transferee's basis equals sum of annuity payments made, plus the actuarial value of the future payments. However, if the asset is still retained by the transferee at the death of the transferor,

then the transferee's basis is equal to the payments made to the transferor. Still, estate taxes (47%) are significantly higher than income taxes—federal capital gains rate is 15%—so the lower income tax basis might not be disadvantageous in comparison.

3. Life Expectancy. If annuitant outlives life expectancy the annuity payments will exceed the value of the property at the date of the transfer.

4. No Interest Deduction. The person making the annuity payments does not receive an interest deduction for any of the payments made even though the annuitant will have to declare a portion of the payments as interest income.

5. No Security. Asset must be transferred on an unsecured basis.

E. Material Comparisons with Self-Canceling Installment Notes.

1. Both provide transfer tax benefits.

2. With a self-canceling installment note ("SCIN") the term of the installment note issued in connection with the sale of property expires on the earlier of the seller's death or the stated term of the note. In exchange for this cancellation feature, the buyer pays a risk premium to compensate the seller for the cancellation feature. Thus, additional amounts are required to be transferred to the seller with a SCIN than would otherwise be transferred to the transferor in a private annuity, possibly causing additional amounts to be included in the seller's estate.

3. The buyer in a SCIN may obtain an income tax deduction for interest paid, while the transferee in a private annuity obtains no income tax deduction.

4. Unlike with a private annuity, the seller in a SCIN may require security in exchange for the buyer's promissory note, without jeopardizing the availability of installment sales reporting.

5. The remaining deferred gain on a SCIN must be recognized at the death of the seller. At least one circuit court has taken the position (and it is the position of the IRS) that the gain constitutes income in respect of a decedent, meaning that this could result in a bunching of income on the decedent's estate tax return, and that there is no estate tax deduction for the decedent seller's share of income tax liability or any loss deduction for any unrecovered basis. This is not the case with a private annuity, because there is no income to the decedent or the decedent's estate in that case.

6. As a general rule, a private annuity should be utilized most frequently when the poor health of the transferor indicates the taxpayer may live beyond 12-18 months, but not to his or her actuarial life expectancy.

F. Material Comparisons with Conventional Installment Notes.

1. No transfer tax benefits.

2. With an installment note, the term of the installment note issued in connection with the sale of property does not expire on the seller's death, meaning that the note will be included in the seller's gross estate as income in respect of a decedent.

3. The buyer in an installment sale may obtain an income tax deduction for interest paid, while the transferee in a private annuity obtains no income tax deduction.

4. Unlike with a private annuity, the seller in an installment sale may require security in exchange for the buyer's promissory note, without jeopardizing the availability of installment sales reporting.

G. <u>Ideal Circumstances to Use Private Annuity.</u>

1. Seller's estate will be subject to federal estate tax.

2. Transferred property generates income and/or is appreciating.

3. Buyer is capable of making the annuity payments.

4. Seller has other income and resources on which to live.

5. Seller may live beyond 12-18 months, but not to his or her actuarial life expectancy.

H. Example.

Taxpayer, age 65 with substantial assets, desires to transfer investment real property with a fair market value of $1,000,000 and a tax basis of $100,000, to child in a transfer tax-efficient manner. The real property is appreciating 5% each year. Taxpayer dies 10 years after transfer of real property to child.

1. No Planning.

a.	Value at death:	$1,628,895
b.	Federal estate tax:	$765,581
c.	Value removed from estate:	$0
d.	Transfer tax savings:	$0
e.	Income tax saved due to step-up:[1]	$144,646
f.	Net tax payable:	($620,935)

2. Private Annuity.

a.	Value at death:	$1,628,895
b.	Annual required payout:	$93,194
c.	Total payments made:	$931,940
d.	Income tax paid on payments:	$265,420
e.	Value removed from estate:[2]	$956,321
f.	Transfer tax savings:	$449,470
g.	Income tax saved due to step-up:	$0
h.	Net tax savings:	$184,050

3. Self-Canceling Installment Note.[3]

a.	Value at death:	$1,628,895
b.	Annual required payout:	$102,119
c.	Total payments made:	$1,021,190
d.	Income tax paid on payments:	$300,156
e.	Income tax on deferred gain	$164,588
f.	Value removed from estate:	$907,861
g.	Transfer tax savings:	$426,695
h.	Income tax saved due to step-up:	$0
i.	Tax benefit of interest deduction:	$189,634
j.	Net tax savings:	$151,585

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[1] This outline assumes 23% combined Federal and state capital gains tax rate, and 38% combined Federal and state income tax rate.

[2] Includes reduction for income tax paid on payments, and takes into account annuity payments received. This outline also assumes that the taxpayer has substantial assets from other sources, and is not consuming any portion of the payments received.

[3] Assumes a 19 year term (early expiration on death), and principal risk premium.

4. Installment Sale.

a.	Value at death:	$1,628,895
b.	Annual required payout:	$78,887
c.	Total payments made:	$788,870
d.	Income tax paid on payments:	$230,538
e.	Portion of note included in estate:	$615,113
f.	Value removed from estate:	$1,070,563
g.	Transfer tax savings:	$214,062
h.	Tax benefit of interest deduction:	$153,514
i.	Net tax savings:	$137,038