Protective

ESTATE TAX CONCEPTS

Private Annuity

The Concept...

- A private annuity is an exchange of valuable (often highly appreciated) property for a lifetime income and involves a buyer that does not regularly issue annuities. For example, a business owner might transfer the ownership of the business to a daughter in exchange for a lifetime income.
- A private annuity can also help spread capital gains tax liability over many years, as well as avoiding gift and estate taxes.

The Process...

- The owner of an asset irrevocably agrees to exchange that asset for an annuity with a present value equal to the property's fair market value. This must be an equal exchange to avoid possible gift tax implications.
- A simple contractual agreement between the parties spells out the purchase price, the annuity payment, and the obligations of both parties.
- The buyer takes control of the property and agrees to pay an annuity to the seller.
- The seller's annuity—a lifetime income as determined by the actuarial tables and applicable federal interest rate at the time the agreement is made—is unsecured by any continuing interest in the asset transferred to the buyer.

The Tax Picture...

- The traditional advantage of a private annuity is the seller's ability to spread the capital gains from the sale over the seller's life. However, proposed regulations issued in 2006 would require the seller to recognize all gain in the year of the transfer.
- Each annuity payment is taxed according to whether the payment represents a recovery of capital in the asset, capital gains realized on the asset's appreciation, or ordinary income.
- The buyer's basis in the asset is equal to the present value of the annuity.

The Bottom Line...

A private annuity is a relatively simple way to transfer a business interest or other wealth. It is especially useful when the buyer can't pay the entire purchase price up front, the seller wants the financial security of payments for life, and the asset produces a cash flow that can be used to make the annuity payments.

SUMMARY

What Is a Private Annuity?

A private annuity is an agreement under which one party sells an asset to a second party in exchange for the buyer's unsecured promise to make a fixed annual annuity payment. For example, a business owner might transfer the business to children in exchange for a lifetime income.

What Are the Advantages?

A traditional advantage of the private annuity is the seller's ability to spread the capital gains over his or her life expectancy (as long as the annuity is unsecured). However, proposed regulations issued in 2006 would require the seller to recognize all gain in the year of the transfer.

The lifetime annuity payments can also supplement a small business owner's retirement income at the same time the private annuity removes a sizable asset from the owner's gross estate.

In addition, a seller can use a private annuity to create income from a non-income producing asset, such as real estate.

Finally, a private annuity lets a property owner transfer the asset without incurring gift tax, possibly allowing the buyer to acquire an asset without paying the entire purchase price up-front.

How Does It Work?

A private annuity is a legal contract. The buyer acquires legal title to the asset in exchange for a lifetime income stream that is taxed like a commercial annuity.

Example: Frank owns an 80% share of a family business with a net worth of $1 million. He transfers his entire interest—clear title with no residual interest—to his daughter, Zoe, in return for her agreement to pay him a private annuity with a present value of $800,000. The value of the annuity payment is based on actuarial tables and the applicable federal rate (AFR) in effect at the time the agreement is executed. The annuity must be paid according to a regular schedule.

What Are the Tax Consequences for the Buyer?

The buyer's basis in the asset is the present value of the annuity. The buyer may be subject to gift tax liability if the present value of the annuity is greater than the asset's fair market value.

What Are the Tax Consequences for the Seller?

An individual who sells an appreciated asset will recognize gain to the extent that the annuity's present value exceeds the property's adjusted basis. The gain may be ordinary income or capital gain, depending on the kind of property transferred, the seller's holding period, and any recapture of depreciation that may be involved. The gain can be spread over the seller's life expectancy, provided that the buyer's promise to pay is unsecured (note that proposed regulations require any gain to be recognized in the year of the transfer).

Tax on the annuity payments is made up of three distinct elements: (1) tax-free payments for the recovery of the seller's original investment in the asset under the annuity exclusion ratio, (2) capital gains tax on the difference between the original basis and the annuity's present value as projected

over the seller's life expectancy, and (3) ordinary income tax on all income beyond the recovery of basis and capital gain.

The seller may be subject to gift tax liability if the asset's fair market value is greater than the present value of the annuity.

What Are the Risks?

Each party to a private annuity takes on a mortality risk. The seller risks that death may occur before reaching his or her life expectancy, which would mean that the seller would not have received all projected annuity payments. Conversely, the buyer risks that the seller may outlive his or her life expectancy, meaning annuity payments would continue beyond the projected period.

The seller also assumes the risk that the buyer may be unable to pay the annuity, since the annuitant's claim against the buyer is unsecured by any further interest in the transferred asset.

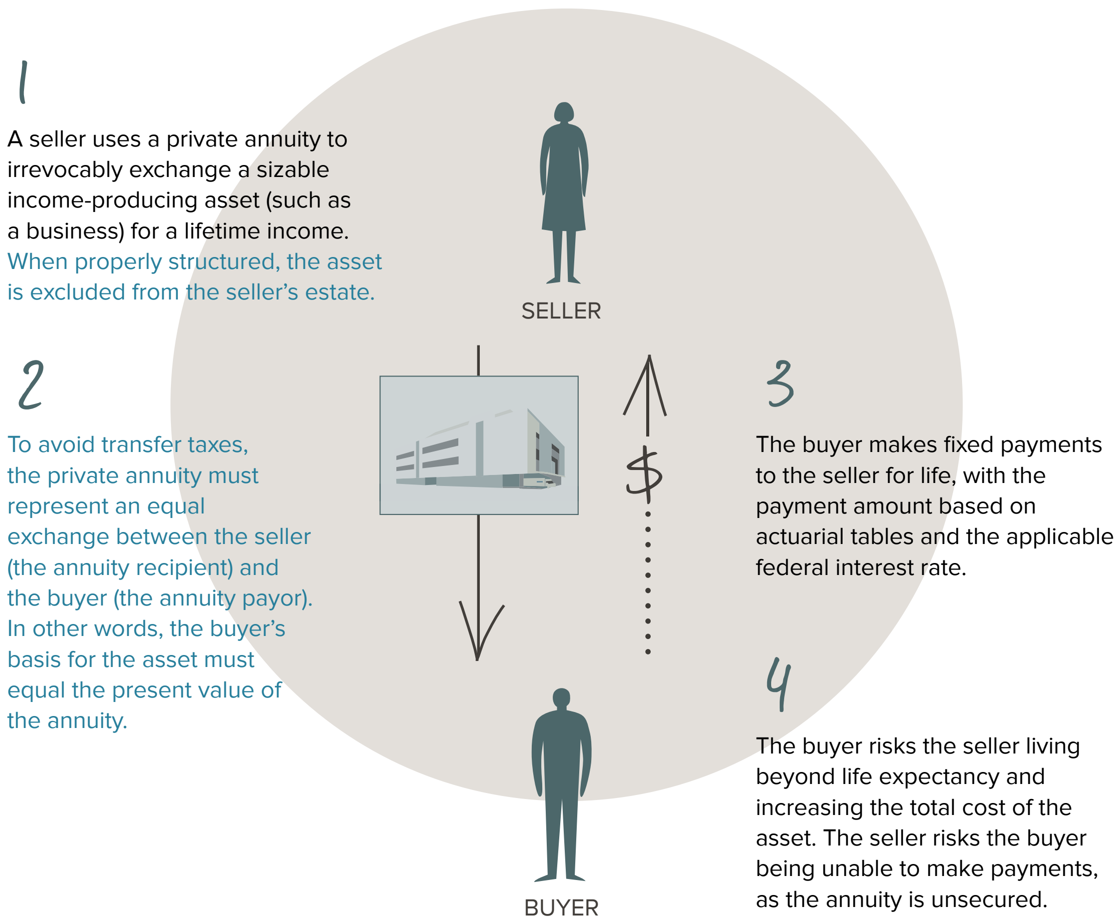
Additionally, in an intra-family transfer, there is a possibility that the private annuity arrangement could create tension between family members.

It is important to note that, if the seller has a terminal illness, the average life expectancy under the IRS tables should not be used. Using the seller's actual life expectancy can avoid adverse gift tax consequences.

What Is the Conclusion?

A private annuity is a relatively simple way to transfer an asset. However, the exchange should be equal to preserve the tax and financial advantages private annuities can offer. The agreement should be formal, with both parties retaining legal counsel, obtaining independent appraisals, and using the proper actuarial tables and interest rates.

A private annuity can be especially beneficial when the transferred asset produces a cash flow (or can be converted to provide a cash flow) sufficient to make the annuity payments.



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A seller uses a private annuity to irrevocably exchange a sizable income-producing asset (such as a business) for a lifetime income. When properly structured, the asset is excluded from the seller's estate.

2

To avoid transfer taxes, the private annuity must represent an equal exchange between the seller (the annuity recipient) and the buyer (the annuity payor). In other words, the buyer's basis for the asset must equal the present value of the annuity.

3

The buyer makes fixed payments to the seller for life, with the payment amount based on actuarial tables and the applicable federal interest rate.

4

The buyer risks the seller living beyond life expectancy and increasing the total cost of the asset. The seller risks the buyer being unable to make payments, as the annuity is unsecured.

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