ESTATE PLANNING TODAY
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Private Annuities

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Annuities are usually issued commercially by insurance companies. But in a private annuity, a contract is signed between one private party (the transferor) to transfer ownership of certain property to another private party (the buyer). In return for the transferor's transfer of property, the buyer makes periodic payments to the transferor for a specified period of time (usually the lifetime of the transferor).

When used as an estate planning tool, a parent is usually the transferor, and a child, or children collectively, will be the buyer. Therefore, in the discussion below, we refer to the "Parent" as the transferor, and the "Child" as the buyer. A joint and survivor annuity with both parents is possible, but, for the sake of illustration, only a single-life annuity with one parent is discussed below.

Let's say that Parent, age 70, has a valuable asset purchased or inherited years ago at a value of $250,000 (its "tax basis" for computing capital gain). The asset currently has a fair market value of $500,000. Parent transfers the asset to Child in return for Child's promise to pay an annual annuity amount to Parent for life, regardless of whether that is a short or long period of time. At Parent's death, no further payments will be made. An arm's-length annual annuity payment can be mathematically computed given the facts set out above and an interest rate factor mandated for use by the IRS. The interest rate mandated by the IRS (which the IRS calls the "Applicable Federal Rate" or "AFR") varies based on current market interest rates and is published by the IRS on a monthly basis. Currently, the AFR is a historically low 3.0%. Based on that rate, the required annual annuity payment from Child to Parent is approximately $47,000. At age 70, Parent has a life expectancy of 16 years, (so total payments are expected to be about $750,000). But if Parent lives only another five years, over $250,000 of value has been shifted from Parent to Child at no estate or gift tax cost.

But note what happens if we do not have the benefit of historically low interest rates. If we run the same calculation assuming an AFR of 7.6% instead of 3.0%, the required annual payment from Child to Parent is approximately $65,000--approximately 38% greater than the payment required using today's AFR. Since the IRS started issuing the AFR in 1989, the trend for that rate has been downward. It started at 10% in January of 1989 and has a long-term average of 7.6%. Thus, the current July 2003 rate of 3.0% (the lowest rate ever) is less than half the long-term average and is only approximately 25% of the all-time high rate of 11.6% in May of 1989. Only three years ago–July 2000–the AFR was 8.0%. The math lesson, therefore, is simple: regardless of the comparison used, the AFR is now a "bargain rate," and estate planning techniques like the private annuity benefiting from a low rate should have a lot of sizzle.

In addition to low interest rates, currently depressed investment values create an opportunity for perhaps double the sizzle for some taxpayers in terms of transferring wealth to the next generation. As painful as the investment environment has been for the last three years, if Parent is in a position to transfer an asset that has lost substantial value in recent times (but is expected to appreciate, at least if the investment markets as a whole bounce back), Parent has an opportunity to "sell" the asset to Child at what should prove to be a bargain in the long run and also get the benefit of lower required annuity payments from Child based on current low interest rates.

Reduced to its essentials, a private annuity is a calculated bet that Parent will not live to life expectancy and/or that the investment will grow in value at more than the AFR. The bet is a good one when, as now, we have generally depressed asset values and historically low interest rates.

In the world of estate planning, there are "bet-to-die" techniques and "bet-to-live" techniques. The private annuity, as seen above, is one of the bet-to-die techniques. However, in the current interest rate and investment environment, the private annuity may benefit even taxpayers who are expected to live close to or beyond a normal life expectancy. Taxpayers in good health with a favorable family medical history may want to borrow from the diversification principle of the investment world and use a combination of one or more bet-to-die techniques and one or more bet-to-live techniques to hedge his or her bet on life expectancy. In other words, at least one bet-to-die technique may be appropriate in the overall estate plan, and low investment values and low interest rates mitigate--perhaps substantially mitigate--Parent's estate planning downside risk of receiving annuity payments from Child beyond normal life expectancy.

Other Benefits/Uses

In addition to shifting future wealth from Parent's estate to Child, the private annuity arrangement has other benefits and uses. Some of them are:

Spread and defer capital gain: If Parent has a low tax basis in an asset, Parent can defer and spread the gain over many tax years rather than bunching that gain all into one year. Any capital gain not reported by Parent's death would never be reported by Parent or Parent's estate.

Create retirement income for life: Generally, a private annuity is used where Parent clearly has substantial means and a taxable estate. But sometimes it is used for parents on the opposite end of the continuum. If Parent owns a non-income producing asset and wishes to boost annual income, selling it to Child keeps the asset in the family, and yet, Parent's income can be increased significantly. In a private annuity, by definition, Parent cannot outlive the income stream. *T*

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Assure succession to specified individual(s): If an individual wants specific assets (e.g., stock in a closely held corporation or cherished land) to pass to one child rather than another or does not want a spouse or creditor to be able to obtain that asset, the individual can be sure that only the chosen party will receive the property.

Create market for business interest: An individual could sell all or a portion of a business interest to certain individuals (e.g., employees) who want to buy into the business but could not afford either a lump sum payment or sizable installment payments.

Easier to implement than some techniques: Though the private annuity is a sophisticated and powerful tool, the documentation for a private annuity is relatively straightforward and less complicated than the paperwork involved in many other advanced estate planning techniques. In addition, the basic concept of an annuity is easy to understand.

Downsides

If Parent lives past life expectancy and the annuity payments are essentially "overpaid," Parent and Child might feel the arrangement did not accomplish its objective of reducing the size of the Parent's estate. But most estate planning techniques have more than one potential downside, and the private annuity is no exception. The other key downsides are:

Parent's annual payment of income tax: The trade-off for potential avoidance of substantial estate tax is that Parent will have to pay annual income tax on a portion of each annuity payment received. (See the discussion of tax implications below.) But if Parent's income tax bracket is low relative to Parent's estate tax bracket, this trade-off alone may make the transaction worthwhile, especially in view of the recent reduction in capital gains tax rates to 15%. Also, in some cases the tax basis of the asset sold in the annuity transaction is close to its current value (e.g., surviving spouse might sell an asset receiving a step-up in basis at the death of the first spouse), so this potential negative factor is substantially mitigated in those cases.

No collateral: Under current tax law, Parent cannot require Child to provide any type of escrow account or collateral (including pledging the transferred asset itself). If Child fails to make a payment, Parent's recourse would be to sue Child on a year by year basis. This factor points up the reason why it would be a rare situation where a Parent would sell all of his/her "eggs" in return for a private annuity (just like no investor should put them all in one basket). This dependence on the willingness and ability of the buyer to make payments is the reason almost all private annuities are between family members and one of the major reasons why the private annuity is considered a sophisticated technique not appropriate for all taxpayers.

Loss of control: Parent should be mindful that Parent is selling outright ownership of the subject property. Once sold, Child and not Parent has control. If Parent's

business is sold, the psychological implications are obvious. However, by selling less than a majority interest, or by selling only nonvoting stock, or by selling only limited partnership interests (and retaining general partnership interests), Parent can continue to not only control the business and its underlying assets but also help the next generation transition to responsible, experienced management.

Child dies before Parent: Because Parent must rely on the unsecured promise of Child for the annuity payments, if Child dies or becomes permanently disabled, the future payment of Parent's income stream could be less certain. However, the executor of Child's estate would still have a continuing contractual obligation to make the required annuity payments. And, if this issue puts Parent beyond his/her comfort level, life insurance on the life of Child could be purchased as a means of solving this problem.

Annuity payment not tax deductible by Child: Child may not deduct any portion of the annuity payments to Parent, including the portion of each annuity payment Parent must report as ordinary income. Moreover, Child will be credited with basis for the purchase price, so the trade-off is a higher basis, translating into deductible depreciation or lower capital gain.

Child may not be able to afford payments: Under current tax law, Child must be able to make payments without total dependence on the income produced by the property itself. If the annuity is structured so that payments are dependent on the income produced by the property sold in the annuity transaction, the IRS will characterize the arrangement as a gratuitous transfer to be brought back into Parent's taxable estate. Thus, the ideal situation involves Child who has significant income and/or assets of his/her own.

Parent dies "too soon": If Parent dies soon after entering into the private annuity transaction, it is possible that, upon resale of the subject property, Child (now the seller) would wish he or she had a higher basis. (At Parent's death, Child's basis becomes the total actual amount paid for the property by Child.) But, where death taxes will be due, Child likely will prefer a higher capital gain tax on some future resale to the continuing obligation to make payments to Parent.

Tax Considerations

Gift Tax: Assuming the present value of the stream of dollars promised by Child to Parent equals the value of the property given up, there will be no gift from either Parent or Child.

Estate Tax: Property sold by an individual for full and adequate consideration before death is not taxable in his estate. Therefore, if the private annuity is properly structured on the front-end, the value of the property sold to Child in return for Child's promise to pay the annuity is excludable from Parent's taxable estate. Likewise, the value of the future annuity stream to Parent will be excludable. This is because the annuity stream will expire upon Parent's death.

Generation-Skipping Transfer Tax: In the past, taxpayers succeeded in avoiding estate and gift taxes at the generational level of their children by leaving assets directly to grandchildren. In order to stop that type of planning, Congress put in place a complicated tax regime known as the "generation-skipping transfer tax" ("GST"). Because a private annuity is a sale and not a gift, it will not be subject to GST tax. Note that this result creates a planning opportunity. If the taxpayer's estate is very large and if one or more grandchildren will be major or sole heirs, GST tax can be avoided by structuring the transfer of assets to grandchildren in the form of a private annuity as opposed to a more classic gratuitous transfer that will cause transfer taxes to be imposed.

Income Tax: Typically, each annuity payment made by Child to Parent consists of three elements--tax-free return of capital, capital gain, and ordinary income. More precisely as a somewhat simplified overview, Parent's "basis" in the asset transferred ($250,000 in the example above) is recovered pro rata over Parent's life expectancy; capital gain is determined by reducing the present value of the annuity by Parent's basis and then the result is divided by Parent's life expectancy; and ordinary income is the difference between the total of the annuity payments each year to Parent less the sum of the return-of-capital and capital gain elements. In the example above, the annual annuity payment of approximately $47,000 is treated as follows: $16,000 is treated as a tax-free return of capital, $16,000 constitutes capital gain, and the balance of $15,000 will be taxed as ordinary income. (Note that in the scenario where the AFR is 7.6% instead of 3.0%, the capital gain and tax-free return of capital amounts are the same but the amount taxed as ordinary income increases to $33,000. Therefore, a lower AFR lowers the ordinary income that must be recognized by Parent from each annual annuity payment.)

Basis: The Child receives a "temporary basis" in the property essentially equal to the value of the property being purchased. This provides a means for immediately increasing the basis for depreciation or depletion and can be a very significant benefit. The same basis is available for sale of the property, leaving little, if any, gain to be then taxed; this may make it easy to diversify assets and

thereby increase financial security yet defer a great deal of the gain.

However, upon Parent's death, the basis is adjusted to what Child actually paid in annuity payments. If Child has retained the property, the only concern for imposition of income tax would be Child having depreciated the property, if applicable, below the "adjusted basis"; in that event, Child would realize a gain to the extent of the difference. However, if Child had sold the property for a price reporting basis at substantially more than the amount paid, the excess will then be taxed to Child.

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Conclusion

The ideal situation for a private annuity involves the following circumstances: (1) Parent clearly has a taxable estate; (2) Child can make payments without total dependence on income from the property itself; (3) Parent trusts Child implicitly; (4) the purchased property is capable of producing at least some income and/or is an appreciating asset; and (5) Parent has less than a normal life expectancy (making the arrangement more of a "bargain"). Currently low interest rates and generally depressed asset values may make using a private annuity feasible where one or both of the last two circumstances are not present.

Contact Us:

Naturally, each estate is unique, and this brief overview should not be treated as a substitute for legal advice. You can reach us at the address and phone number shown below, or by e-mail:

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