CHAPTER 41

Private Annuities – a Simple Strategy for Estate Planning, Business Succession Planning, and Asset Protection

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A sale for a private annuity describes a sale of property in exchange for a privately issued unsecured annuity contract under which a series of payments is made to the seller or annuitant (hereinafter Annuitant) usually for the Annuitant's lifetime. A private annuity is issued by a private individual or obligor, typically a family member; whereas a commercial annuity is issued by an organization in the business of issuing annuities, such as an insurance company. Such a transaction may be useful for estate planning, business succession planning, and asset protection purposes. Most often, appreciated property is sold by a family member in the senior generation to children, or to a trust for their benefit, in exchange for the privately annuity.

ESTATE PLANNING CONSIDERATIONS

For estate tax purposes, the value of property sold for a private annuity is removed from the Annuitant's gross estate. Further, and perhaps more importantly, after the transfer is complete, any appreciation or earnings from such property is now outside of the Annuitant's estate. At the Annuitant's death, the annuity obligation terminates and similar to a Self-Canceling Installment Note (SCIN) nothing is included in the Annuitant's gross estate. In effect, appreciating property that would otherwise be included in the Annuitant's gross estate and subject to estate tax has been converted into a life estate, which will not be included in the Annuitant's gross estate.

A private annuity is a means of transferring wealth between generations without gift tax consequences or immediate income tax consequences (but see discussion of the IRS Proposed Regulations below). Also, because the annuity calculation is based on the Internal Revenue Code (IRC) Section 7520 rate in effect at the time of the annuity and the Annuitant's life expectancy, this strategy may be particularly attractive if the Annuitant has less than a normal life expectancy; in effect creating a bargain purchase for the buyer or obligor. However, IRS actuarial tables cannot be used to value the annuity if the Annuitant is known to have an incurable illness or other deteriorating physical condition, such that there is at least a 50% probability that the Annuitant will die within one year.

Another advantage of a private annuity is that the Annuitant receives a stream of payments or cash flow for life. A private annuity may, in effect, provide a means of generating cash flow from otherwise non-income producing property.

Business Succession Planning

In certain circumstances, the private annuity strategy may also serve as an effective means of succession planning or exit planning for a closely held business. The private annuity can be used to transfer business ownership interests, either in increments or all at the same time, from the owner to junior family members without gift tax consequences, while providing the owner with a cash flow for life generated from the cash flow of the business. Given possible immediate income tax recognition as discussed below, it is advisable to obtain a valuation of the business interests from a qualified business appraiser. Such an appraisal should take into consideration various valuation discounts so that the resulting valuation will be the lowest possible supportable value. To this end it may be possible to structure the transaction to achieve significant valuation discounts either through the sale of minority ownership interests, or possibly by contributing the business ownership interests to a Family Limited Partnership or Limited Liability Company prior to the sale.

Asset Protection Possibilities

In some states, such as Florida, an annuity is protected from creditors. Florida Statute 222.14 provides that proceeds from an annuity contract issued to a Florida resident are not subject to attachment, garnishment, or legal process in favor of any creditor of the beneficiary of the contract. The Florida courts have broadly construed this statutory exemption to include both commercial annuities and privately issued annuities between family members. Further, under Florida law there is no limitation on the amount of the annuity that may be protected. Therefore, converting individually owned property, which may be subject to the claims of future creditors, to a private annuity, is a means of asset protection.

Income Tax Consequences

In the past, if appreciated property were exchanged for a private annuity, any capital gain would be postponed and recognized by the Annuitant over his or her lifetime as a portion of each annuity payment received. The IRS approved of this result in Revenue Ruling 69-74. As a result, a private annuity was a particularly useful strategy to transfer highly appreciated property with a large built-in capital gain and defer recognition of that gain.

However, on October 18, 2006, the IRS issued Proposed Regulation Sections 1.72-6(e) and 1.1001-1(j) that generally would require gain (or loss) to be recognized immediately when the property is exchanged for the annuity contract (unless the property exchanged is cash). When finalized, the Proposed Regulations would be applicable to private annuity transactions after October 18, 2006, or after April 18, 2007 where an unsecured annuity contract is issued by an individual. Although there may be changes to the Proposed Regulations which carve out exceptions for private annuities before the Regulations become final, these new rules could make other estate freeze strategies such as installment sales or SCINs more attractive, although each of these strategies also produce income tax consequences to the Annuitant's estate or beneficiaries. Also of concern is whether the capital gain tax rate, currently at a historically low 15%, will increase in the near future.

EXAMPLE

To illustrate the workings of a private annuity, assume an Annuitant, age 60, sells appreciated property with a fair market value of $5 million and a tax basis of $1 million to a junior family member for a lifetime annuity, payable at the end of each year. Based on the Annuitant's life expectancy and a 4.2% Section 7520 rate in effect for August 2008, the Annuitant will be entitled to annual annuity payments of $389,363 for almost 24 years. Each annual annuity payment will consist of a nontaxable return of capital and taxable ordinary income of $210,971 and $178,392, respectively.

Following the Regulations, the Annuitant would be required to pay capital gains tax of approximately $600,000, calculated at 15% on the $4 million capital gain. However, the potential federal estate tax savings, assuming the Annuitant is in the 45% marginal estate tax bracket, is $2,250,000, less the increase in estate tax due to the receipt and retention of incoming annuity payments. Upon the Annuitant's death, the annuity obligation terminates and nothing is included in the Annuitant's gross estate. Finally, any appreciation, growth, and earnings from the property after it is sold for the annuity outside of the Annuitant's gross estate.

Advantages

1. The value of property sold for a private annuity is removed from the Annuitant's gross estate.
2. All appreciation and/or earnings from the annuity property after the sale are outside of the Annuitant's estate and not subject to estate tax.
3. Upon the Annuitant's death, the annuity obligation terminates and nothing is included in the Annuitant's gross estate.
4. A private annuity may result in a bargain sale when the Annuitant's actual life expectancy is less than his or her actuarially calculated life expectancy.

Disadvantages

1. Uncertainty concerning IRS Regulations which require immediate recognition of income upon sale of property for the private annuity.
2. The Annuity is generally unsecured.

Other Considerations

The private annuity may be particularly useful technique to ensure certain property remains inside the family, which may be vital if the property consists of ownership interests in a family-owned or closely held business. However, the Annuitant should be comfortable transferring the property to the obligor, given that the annuity is unsecured. In most cases, the Annuitant should have other assets available to live on in case the annuity is not paid.

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Sale to an Intentionally Defective Grantor Trust vs. a Grantor Retained Annuity Trust

CHARACTERISTIC	IDGT	GRAT
Income stream	To grantor for term of the note	To grantor for term of the trust
Interest rate used to value property transferred	Section 1274 AFR	Section 7520 rate (120% of Section 1274 AFR)
Effect of death of grantor during term	Value of note included in grantor's estate; Post-transfer appreciation in value of underlying property is removed from grantor's estate	Entire value of property held in trust included in grantor's estate, including post-transfer appreciation in value
Allowance of balloon note payments	May be allowed; If note not fully repaid at death of seller, there may be income tax consequences	Not allowed as annuity payments in one year may not exceed 120% of the payments made in the immediately preceding year
Amount of taxable gift	None if note equals FMV of property transferred	If properly structured, zeroed out GRATs with no taxable gifts are possible
Subsequent increase in the value of the property transferred by an IRS audit	Results in dollar-for-dollar increase in amount of taxable gifts	Will not result in a dollar-for-dollar increase in amount of taxable gifts because value of retained annuity interest also increases
Assumption of risk if value of assets decreases	Beneficiaries	Grantor
Disclosure of sale	Required on federal estate tax return (Form 706)	None required if grantor dies after term of trust