

## The Private Annuity Trust – Questions and Answers by Gordon Corwin

If you or someone you know is sitting on real estate with large amounts of equity and are not listing their property in fear of “capital gains taxes”, then you may want to consider a Private Annuity Trust, (“PAT”). There is an IRS approved way out for you -- (Sec.72 of the IRC). This allows you to accomplish several goals:

- Defer the nearly 25% capital gains plus depreciation recapture tax and still sell now.
- Dramatically increase cash in your pocket for life versus paying the tax up front.
- Pay the deferred capital gains tax installments over the years, using the unpaid dollars to work for you.
- Receive fixed monthly annuity payments with a guarantee available.
- Be relieved of property management and tenant problems.

There is a smart, functional, and more importantly, legal way to address these issues. The answer may lay with an old estate planning tool called the Private Annuity Trust.

Under this plan, the owner of commercial or residential property must transfer ownership to their Private Annuity Trust (PAT) prior to the sale of the property. The Private Annuity Trust is a seller's dedicated family trust, which pays the seller with a special payment contract called a private annuity that stipulates that payments from the sale of the property go to the owner for the rest of his or her life. Once the property is sold, cash is generated and held, tax deferred, in the seller's Private Annuity Trust. The property owner / annuitant will earn dramatically more money over the years than he would if he / she sold the property and paid the tax up-front. Here are some specific questions that have been asked.

**What are capital gains taxes?** Capital gains are a tax on the profit we make when we sell assets. Any long term asset sold at a profit is subject to a capital gains tax of some rate. The rate for a significantly sized sale of an asset owned for one year or longer will be 15% for federal taxes. Most states charge 5% to 10% on top of that, making the total tax run as high as 25%. If there is depreciation recapture in the asset sale, that is taxed at 25% federal rate, possibly making the tax on recapture higher than the capital gains tax.

**How is my income taxed?** This is an important question. In any tax deferred sales strategy, you need to know the net after tax dollars your strategy will generate when comparing any strategy. The answer is that it will be taxed at a rate that is below your personal income tax rate. The rate is situation specific.

**So when do I really pay this inevitable tax?** Since the Private Annuity contract calls for payments to be made in installments over the seller's life, the seller is only taxed on payments when they are received, rather than all up front. This strategy is much like the installment sale strategy, but for a few advantages: 1) The Private Annuity strategy will defer depreciation recapture and may defer mortgage over basis taxes. The installment sale strategy will only defer capital gains taxes. 2) The payments in the Private Annuity strategy continue for the rest of the seller's and their spouse's lives jointly. An installment sale strategy may be paid off early by the new buyers and *all outstanding unpaid capital gains taxes will be due at that time*. 3) Everything inside the trust will pass to the seller's heirs free of gift and estate taxes, while in an installment sale strategy, the note is still inside the taxable estate of the seller.

**How much do I get?** The annuity stream depends upon three factors. 1) The age of the annuitants. 2) the principal and 3) the current month's IRS allowable interest rate of AFMR. Typically, the older the annuitant, the larger the income.

**When I sell the property and put the cash in the trust, may I keep some of the cash from the sale?** Yes, in that case you would pay taxes only on the portion of money which you kept for yourself outside the trust.

**How can I have my tax advisor or attorney analyze the private annuity idea?** We will gladly provide your tax advisor with the technical and legal information they need to properly advise you. For a quick answer, have your CPA review IRS Revenue Rulings 55-119 and 69-74, plus the IRS' GCM39503 of 5/19/86 and Treasury Decision TD-8754 issued in 1998, and the Ninth Circuit U.S. Court of Appeals decision “LaFargue v. Commissioner, 689 F. 2d 845 (1982)”.

**I am concerned that my money is SAFELY INVESTED in the PAT; we're too old to risk losing it now.** The Private Annuity Trust comes with prudent investment rules dictated by the IRS. Remember, it is not just your money that the trust holds, but also the deferred tax money of the IRS. Therefore, you would want to be sure that your investments are diversified and prudent.

I would recommend you only use advisors who specialize in trust fund management and have experience in the Private Annuity Trust. An inexperienced investor may create more tax exposure than necessary in your

investment style. Your trust must be designed to give the maximum tax efficient style of investing, while protecting your downside risk and maintaining an unlimited upside potential.

**How is my Private Annuity Trust protected from possible intrusion by my Trustee or my heirs during my lifetime?** Remember, you choose your trustee. Because the trust's main purpose in life is to be sure it can make your annuity payments for the rest of your life, you also have the ability to fire your trustee without cause, thus moving up your originally decided upon successor trustee who will make sure your annuity stream is protected.

Your beneficiaries have no access to the trust funds without the permission of your trustee therefore there should be no reason to fear your beneficiaries "raiding" the trust before their time. The fact that an irrevocable trust is used to hold your investment and invest for the benefit of your annuity stream is what makes it possible to be comfortable with the fact that your investment cannot go anywhere until after you and your spouse are gone.

**Is my annuity payment amount fixed or can I change it up and down?** The annuity holder's income is fixed, meaning that he or she receives a fixed payment amount determined by each Private Annuity's face value, the annuity holder's age and the Internal Revenue Service's stipulated interest rate.

**Can I sell additional properties later on and put these dollars into my PAT as well?** Yes. Your Private Annuity Trust is the trust you use to sell your highly appreciated assets. Any new asset to be sold later simply requires a new annuity contract written by the trust.

**How long can I defer my annuity payments?** Annuity holders can defer payments up to age 70 ½. At 70 ½ payments must begin. Once the payments begin, the annuity holder will receive payments for as long as he or she lives. Often, annuitants will choose deferral because they have other income and don't need the payments right away. Of course, annuity payments may begin immediately. Deferral is strictly an option.

**Is there interest or penalty on these deferred payments of the tax?** No. And the property owner is not taxed on sale since he has not yet received any cash for the sale. On top of that, the tax payments will be made with depreciated dollars. The tax dollars will be worth far less than they are today due to inflation. Yet, the investment money in the trust will grow at a greater rate than that of inflation.

**Who can be a Trustee?** The property owner (seller) or the private annuity holder cannot be the trustee. The trustee, however, can be appointed and replaced by the annuity holder. It can be anybody of sound mind and legal age that the seller wishes - usually a family member. The trustee may also be a financial advisor, family friend, attorney, accountant, etc.

**What about other taxes?** Sellers using the private annuity also can defer taxes know as depreciation recapture, where the IRS recaptures depreciation for which the owner had previously received deductions. It may also defer mortgage over basis taxes. These are taxes that are due if the current lien on the property is above the purchase price of the property. The tax rate is the same as the federal and state capital gains rate.

**What properties count?** Some wonder whether a rented-out single-family home could be sold with the owner using a private annuity. The answer is yes. In fact, a PAT can be used to sell any highly appreciated asset that is exposed to capital gains taxes, such as stock portfolios. Also, cash can be included in your PAT.

There is no maximum to the size of the transaction and the PAT can be used on any kind of real estate transaction such as your primary residence, rental properties, vacation homes, commercial properties, hotels, land, industrial complexes, retail developments, shopping strip malls and even baron land to name a few.

**I thought the estate taxes were going away?** This is a common misunderstanding. The answer is yes they are going away in the year 2010, but if the 2001 tax law is not extended then the "sunset clause" in the tax act will automatically revert back to pre-2001 estate tax levels. Congress has already attempted to extend the tax act nine times since it was first enacted, without success. So, yes the estate tax is going away, but for only one year unless the act can be made permanent. The use of a Private Annuity Trust sale will eliminate the estate tax and the gift tax to the beneficiaries of the seller. It will take that portion of the seller's estate and bring it outside the taxable estate.

**What is my estate tax exposure if I just leave my properties in my Living Trust and do nothing?** The following is the scheduled changes in the estate tax and rates:

<u>Year</u>	<u>Rate</u>	<u>Exempt Amount</u>
2001	55%	\$ 675,000

2002	50%	1,000,000
2003	49%	1,000,000
2004	48%	1,500,000
2005	47%	1,500,000
2006	46%	2,000,000
2007	45%	2,000,000
2008	45%	2,000,000
2010	0%	Unlimited

What this means is that if you are single and died this year (2005), your estate will have an estate tax exposure of 47% for the value of your entire estate above \$1,500,000. This tax would be due within six months of your death and your heirs would be forced to sell property quickly to pay the tax if your cash assets are not sufficient to cover the exposure.

**I thought my heirs would get a 100% step up in basis if I passed on?** It is important to make a distinction here between estate tax and capital gains tax. Your step up in basis refers only to the capital gain tax exposure to your heirs for all of your assets excluding cash. Your estate tax exposure is a completely different type of tax. As for the future of our now enjoyed 100% step up in basis, what the IRS giveth, the IRS taketh away. While it is true that our heirs now enjoy a 100% step up in basis for our property, this tax shelter is being limited after the year 2010. In 2011, the step up in basis is being limited to 1.3 million of the entire estate assets excluding cash.

So, while the estate tax may be extended, the step up in basis will be limited. Worst-case scenario is that the estate tax will not be extended and the step up will be limited. The Private Annuity Trust sale is a way to plan for the worst, but hope for the best in either scenario. A seller can manage the capital gains, depreciation recapture and mortgage over basis taxes, while completely eliminating estate tax and gift tax exposure to their estate. This planning strategy is powerful and should not be overlooked when planning a sales and estate strategy.

**Are there other significant benefits to my heirs?** Yes. Whatever is left in the trust at the time of the annuitant's death will pass to the beneficiaries completely free of estate and gift taxes.

1. This arrangement does not trigger any gift tax consequences no matter how much the property is worth.
2. The property will not need to go through probate when the annuitant dies.

**How can I have a Private Annuity Trust and still keep my Living Trust?** Your Private Annuity Trust is separate and completely different than your Living Trust. The two live side by side. Your living trust simply avoids probate and captures your primary residence capital gains exception for you and your spouse or for you should they pre-decease you.

Everybody absolutely needs and should have a living trust for these specific reasons. There are also medical directives in your living trust that would be followed in case of your incapacitation. Several new rules have gone into effect recently that makes your old living trusts medical directives null and void, so if you established your living trust prior to 2005, you should get your directives updated by your attorney.

**Can I sell first and then set up a Private Annuity Trust later on to defer these taxes?** No. Your trust needs to be the seller of the property. If you have closed escrow on your property, you can no longer use the private annuity trust sales strategy. It is important to know all of your options for tax-deferred exchanges with your property before you sell you property. This is absolutely crucial in being certain you are taking the right course of action as it pertains to your investment goals.

**Can I buy more real estate with trust dollars when this crazy market goes down again?** Yes. Real Estate is absolutely considered a prudent investment. Your trust can buy real estate, or if you are deferring your annuity stream, you can borrow from the trust for the real estate purchase to be in your name. There are advantages and disadvantages with this strategy that can be discussed in your personal valuation.

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