

How Do Wealthy Investors Avoid Capital Gains Taxes? (And are these methods available to you?)

by Jeff Reed and Carlo Sparacino

With Real Estate values at record levels, many property owners have seen their investment properties appreciate rapidly. With a dwindling inventory, we are truly in a seller's market. A perplexity that property owners have is that if they sell, to take advantage of these high valuations, what to do with the proceeds. The idea of a 1031 exchange may sound like an attractive means of capital gains deferral; however, the problem the property owner faces is that he is then paying a premium for the new property. Many economists feel that real estate values are at or very close to a peak in the market. With interest rates increasing, we may see property values cease to appreciate any further, and more likely declining in value.

Another option is an outright sale, however, then you are faced with paying 25-30% of your gains in taxes. An installment sale is yet another possibility many owners consider. An installment sale will defer the capital gains tax but not the depreciation recapture tax. Many installment sales are abandoned because the immediate recapture taxes were greater than the down payment that the seller would have received. You also have the risk of possible foreclosure on the property at a lower valuation.

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There is another alternative that is often overlooked by many property owners. That is the Private Annuity Trust option. Qualified financial planners offer a system to reduce the capital gains and the depreciation recapture tax bite through long-term deferral of the tax. The tax treatment of the plan has been thoroughly documented by specific IRS publications, court cases and legal reference texts*. This plan is known as the Private Annuity Trust.

Private Annuity Strategy

The Private Annuity does not eliminate taxes, but rather defers them for long term, often for decades, and with no penalty or interest for doing so. The deferral takes place because the property owner receives his sale proceeds in a lifetime income stream from a private annuity contract. Capital gains and recapture taxes are paid as the income stream is received.

Nothing is given away to charity as happens with the competing strategy, known as the charitable remainder trust. The Private Annuity allows all the principal and accrued interest to be paid to the property seller, whereas the charitable remainder trust pays the income (interest) only. In most cases the Private Annuity yields more bottom line dollars to the property seller than the charitable remainder trust does.

With the Private Annuity the property owner (seller) places the appreciated assets into a trust, rather than directly selling it to the buyer. The trust belongs to and is controlled by the seller's family. Its beneficiaries are the heirs or children of the property seller. The trust "purchases" the asset from the seller. Instead of a cash purchase the trust pays the seller with an annuity contract. The annuity contract is a private arrangement issued by the trust itself and is not a commercial annuity from an insurance company. The annuity makes the seller an "annuitant" and that is how we will refer to the seller after this. The annuity contract is a promise to make payments to the annuitant for the balance of the annuitant's life. The payments can be made to either a single person or in a joint last-to-die arrangement to a married couple. Often the first payment on the annuity is deferred, maybe for many years down the road, such as when the annuitant has reached retirement age. But the annuitant has the option of beginning the annuity payments right away.

Usually the annuitant has located a "real" buyer for the assets and has negotiated a fair market price for it. If not, that may be done by the trustee after the asset goes into the trust. In any case the sale is not completed until the asset has been placed in the trust. When the transactions are completed the asset has been sold twice. First, from the annuitant to the trust, and paid for by an annuity, and a second, from the trust to a "real" buyer, in either a cash or installment sale.

For reasons too lengthy to explain in this article, neither the sale by the annuitant to the trust nor the sale from the trust to the outside buyer are taxable events *at that time*. When the annuitant begins to receive annuity payments some of each payment will be subject to a fraction of the original capital gains taxable amount. The taxable amount will be spread out in equal payments over the balance of the annuitant's life expectancy. For example, if the annuitant has a 20 year life expectancy at the point the annuity payments begin, the annuitant will pay 1/20th of the capital gains (and recapture) tax each year. The rate of the tax will be whatever the rate is in each year that the 1/20th payment is received by the annuitant. There will be neither penalty nor interest to pay on any deferred taxes. The annuitant will never pay more total tax than he would if he paid the taxes up-front (assuming the tax rates stay the same or decline).

If the annuitant lives to the exact life expectancy that the annuity was based on the annuitant will end up paying all the capital gains on the sale. But the first payment may be ten, twenty or more years after the annuity sale. Then the annuity payments spread the capital gains taxes over another ten, twenty or more years. This means that the payment of capital gains taxes could be spread out over a total time span of as much as fifty years with no penalty or interest on the deferral. This allows the trust to use the entire cash proceeds, including the unpaid taxes, to invest in any worthwhile investment. The unpaid and deferred taxes remain in the trust to work alongside the rest of the sale proceeds to produce a much larger amount of income. *At the death of the second annuitant the trust assets pass to the designated beneficiaries, Estate and Probate Tax-Free. For more information, see Jeff Reed speak on the following dates:*

Long Beach Convention Center

AOA "Million Dollar" Trade Show
Saturday April 16, 2005
9:00 am – Seminar Area B
Long Beach Convention Center

AOA Van Nuys Office

~ Luncheon ~
Thursday April 21, 2005
12:00 pm – 2:00 pm
Contact Allison at AOA for reservations
(818) 988-5921

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