

STUPID PRIVATE ANNUITY TRICKS

by Joseph Petrucelli, JD, LLM

When carefully planned and properly used, private annuities can be very powerful tax deferral and estate planning tools. Like any such tool, however, private annuities do come with significant limitations and complexities. With the recent boom in the real estate markets and sellers desiring to defer the capital gains on the sale of their property, many unscrupulous and often unqualified promoters have started hawking private annuities to the masses by promising them a tax planning panacea that is simply not supported by the tax laws. Persons who are about to sell an asset and defer capital gains through the sale of a private annuity should be cautious about the following practices. As with all complex tax planning strategies, the review of the transaction by an independent tax attorney who is familiar with private annuity transactions is not only suggested, but is essential, since the tax consequences if a private annuity fails or if the payments are not calculated correctly can be horrendous to the seller. ~ Betty Nguyen, Editor Adkisson & Riser's Developments in Asset Protection and Wealth Preservation.

1. Too Late Sales of Property via Private Annuities

Recently, a number of people have inquired about using Private Annuities to defer income tax on the sale of property that has already been placed in escrow. This poses significant tax issues under some or all of the Assignment of Income, the Step Transaction and the Sham Transaction Doctrines. Under the Assignment to Income doctrine, the Courts have consistently held that when a person attempts to shift income to a different taxpayer after the income has been earned, the income will be taxable to the taxpayer who earned the income rather than the taxpayer to whom the income was shifted. Once property has been placed in escrow, it would be difficult to argue that the property was actually sold by a "Private Annuity Trust" or any other form of Annuity Obligor.

Further, merely pulling the property out of escrow and then placing it immediately back into escrow with a newly named "seller" will likely not remedy the situation. In such an instance, an argument would likely be made that the Annuity Obligor is simply acting as agent for the real seller of the property and the IRS would likely prevail in such an instance.

2. Using Private Annuities to Sell Commercial Annuities

Over the past 18 months or so, several organizations have begun marketing the use of Private Annuities as a means of deferring capital gains on the sale of real estate. Generally, these marketing groups have as an added agenda, the "management" of the money earned by the "Private Annuity Trust." The management consists typically of the purchase of commercial annuities from life insurance or annuity companies. There are several problems with this strategy.

First, is that these marketing organizations often do not have much experience in the use of Private Annuities.

Second, the transaction is susceptible to challenge by the IRS as a Step Transaction. Generally, a Private Annuity transaction should not be susceptible to a challenge under the Step Transaction doctrine because they are generally intra-family estate planning devices that do not result in the exchange of an asset for a different asset. However, when real estate is being sold and "replaced" with a commercial annuity, the IRS may argue that the use of the Private Annuity is nothing more than a device to trade real estate for a commercial annuity. Because there are no provisions in the Internal Revenue Code or under Federal tax doctrines which allow a direct exchange of real estate for commercial annuities without taxation of the transaction, the use of a Private Annuity as an intermediate step will not be recognized as a valid tax

transaction and the IRS may collapse the transaction and consider the taxpayer to have sold property and bought the commercial annuity with what amounts to after-tax dollars. This could result in immediate taxation of the entire gain associated with the sale of the real property.

Additionally, certain provisions of the Code may result in inclusion of the commercial annuity in the estate of the taxpayer.

3. Long-Term Deferral of Private Annuity Payments

While it is possible to defer the payment of Private Annuities for some period of time, there is no bright line test in the Code or under Federal tax law for the length of deferral. Certain marketing organizations have adopted the “rule” that an annuity may be deferred until age 70½. While this may be legal, it can pose significant issues with the calculation of the annuity payments due from the “Private Annuity Trust.”

Generally, a private annuity will be treated as a sale of property and therefore not subject to gift tax as long as the Fair Market Value (“FMV”) of the property is equal to the Present Value (“PV”) of the stream of Private Annuity payments.

Generally, for the PV of the Private Annuity payments to remain equal to the FMV of the property transferred to the trust, the annuity payments would have to increase for periods of deferral. The use of a commercial annuity as the sole funding mechanism may not result in the necessary accrual of value to ensure the PV of the Private Annuity stream remains equal to the FMV of the property. It should be noted, that for the transfer of property to be considered a gift, there would also need to be some gift intent so whether there is some disparity between the PV of the Private Annuity and the FMV of the property there may not automatically be a gift tax due.

However, if there is a significant difference between the PV of the Private Annuity and the FMV of the property that was originally transferred, the transfer of the property to the Annuity Obligor might be considered a fraudulent conveyance as something other than a transfer for reasonably equivalent value. A disparity between the PV of the Private Annuity and the FMV of the property could also result in the property transfer not being considered a sale and therefore subject to inclusion in the estate of the taxpayer under §2036.

4. Canned Opinion Letters

Changes to Circular 230 have made it less appealing to rely on tax opinions as a means of avoiding potential penalties associated with the assessment of tax by the IRS. While a properly drafted opinion letter should still be able to be reasonably relied upon in good faith by a taxpayer, opinion letters provided by promoters (or the counsel of promoters) of the use of Private Annuities as a means of deferring capital gains tax with an eye toward selling commercial annuity products should not be relied upon and independent counsel should be used to provide an opinion letter upon which a taxpayer can rely to avoid penalties. Where time allows, a more prudent course of action would be to obtain a Private Letter Ruling on aspects of the Private Annuity transaction. If a promoter advises against the taxpayer obtaining a Private Letter Ruling, the taxpayer should take this as a sign to be cautious in dealing with the promoter.

5. Private Annuity Trusts

The term “Private Annuity Trust” has become a part of the new lexicon of estate/tax planning (as well as insurance and real estate sales seminars). However, there is no such thing as a “Private Annuity Trust”

and it is no special species of trust anymore than a “Family Limited Partnership” is a special species of limited partnership. Ultimately, a trust that is used as an Annuity Obligor is either a grantor or non-grantor trust (or potentially some hybrid of the two). The tax treatment associated with the Private Annuity transaction is largely dependent on how the trust will be treated. It should be noted that in some instances, companies marketing “Private Annuity Trusts” tout the use of trusts which begin as a grantor trust and then later become a non-grantor trust. In such an instance, it is highly likely that the conversion of the trust to a nongrantor trust following the transfer of property to the “Private Annuity Trust” will have no effect on basis of the property and that there will be no tax deferral available as a result of the conversion of the trust.

6. Basis if no payments

While most private annuity arrangements end up in the property that was transferred to the obligor being sold, there are instances when an obligor may hold property for some period of time prior to the property being sold. In such an instance, if no annuity payments have been made and the annuitant passes away, the obligor will have zero basis in the property and therefore would be taxable on the full amount of the gain associated with a later sale of the property. Many promoters fail to point this risk out to their clients. Certain steps can be taken to reduce this risk, if desired, but many promoters may not understand the issue, let alone the potential ways of mitigating the risk.

7. Ballooning Payments

Many promoters extol the virtue of deferring the start of the annuity payments due in a private annuity transaction. While it is true that in certain circumstances there may be benefits to deferring the start of the annuity payments, many promoters fail to understand the long-term effects of the deferral. In a properly structured private annuity transaction, the fair market value of the property transferred for the annuity should equal the present value of the annuity stream. This “test” needs to be made as of the date of the transfer of the property. This means that as annuity payments are deferred, they must increase in size to keep the present value of the annuity stream equal to the fair market value of the property. This means that the required annuity payments may become very large if the annuity starting date is deferred for a long period of time.

8. Trust Taxation Issue

A fundamental issue to consider is that the trust/obligor of in a private annuity transaction is a taxable entity (or the beneficiaries of the trust are taxable) and that the obligor must therefore pay tax on income it earns.

9. No Deduction

The obligor in a private annuity transaction does not receive a tax deduction for the annuity payments. Because the obligor is taxable on its income, the obligor may be in the position of having to satisfy annuity payments with after-tax dollars which can significantly raise the economic cost of the transaction.

10. Estate Tax

Most private annuity promoters will list mitigation of estate tax as a benefit of utilizing a private annuity transaction. While this is true, what many promoters will fail to point out is that the annuity payments received by the annuitant are typically received back in their own name and therefore each payment that is

received rebuilds the taxable estate of the annuitant. Once again, there are ways to mitigate this potential problem but most promoters will not consider means of mitigating the problem.

11. Stop and Go Annuity

The “stop and go” annuity is another problem. Once annuity payments begin, they should not be stopped. The definition of an annuity revolves around periodic payments being made. If the annuity contract allows payments to begin and then cease, there is a question as to whether the contract is actually an annuity.

12. Live Too Long

Private annuities can result in the annuitant paying more tax than they would have if they paid the tax at the time of the sale. Additionally, a private annuity transaction can result in the conversion of capital gains to ordinary income. This can happen in a situation when the annuitant outlives his or her actuarial life expectancy. All payments made by the obligor after the date of the annuitant’s actuarial life expectancy are ordinary income because the annuitant will have received back all of his capital gains and his basis.

13. No Asset Protection for Annuity Payments

One of the benefits of using a private annuity is the potential for asset protection. However, the payments received by the annuitant are subject to creditors in most instance and generally private annuity transactions are not structured in a way that will provide asset protection to the annuity payments.

14. Annuitants Are Not Entitled to the “Growth” in the Annuity

When an annuitant exchanges property for a private annuity, the annuitant is entitled to an annuity stream equal to the fair market value of the property transferred. So, if property valued at \$500,000 is transferred to the obligor, the annuitant is entitled to a \$500,000 annuity. The obligor, particularly in situations where an annuity is deferred, might accrue significant value in excess of the original fair market value of the property transferred for the annuity. Some promoters will build in “interest” for foregoing the annuity payments. They may also draft a private annuity in such a manner that the annuity will be made up of the accrued value of the annuity obligor. In these situations, it is possible that the annuity calculations will not result in the appropriate “balance” between the fair market value of the property and the present value of the annuity. If a client wants to have what amounts to a variable annuity or to have “access” to the growth of the annuity obligor, the client should seek a private placement annuity.

15. Private Annuities Are Not “Exchangeable”

In certain instances, promoters will seek to defer payments by having a client exchange the original annuity for a new “revalued” annuity. The re-valued annuity will often include the accumulated value of the annuity obligor. There are several problems with this but the glaring one is that the provisions of the Internal Revenue Code which allow the exchange of annuity contracts probably do not apply to private annuities. Therefore, such an exchange of annuity contracts would likely result in taxation.

Joe Petrucelli, JD and LLM (tax) is a California tax attorney with offices in San Diego County, California and may be contacted at 760.431.4575.