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PRIVATE ANNUITIES – TRADING ASSETS FOR INCOME

The Private Annuity is a tax planning technique worthy of consideration. It is a particularly attractive solution in the current market where asset values are depressed and interest rates are low. In this technique an asset or cash is exchanged with a third party or entity for a series of equal payments for the person's lifetime. If the transaction is properly structured the result is that upon the person's death, the asset passes outside of the individual's estate.

Ideally, the Private Annuity would be between a parent and their children or the parents and a trust for their children's benefit. The parents end up with a stream of payments for their lifetime and the children end up with the asset on the death of the parents, free of estate taxes. Because the income payments are significant and must be made, the assets exchanged for the annuity must be assets which produce at least enough income to make the payments.

The Private Annuity is a legally enforceable contractual right between the parties. To avoid gift taxes, the contracted-for present value of the annuity payments must equal the fair market value of the asset being sold. In many cases the annuity payment is significant and places a requirement for high cash flow and liquidity on the party now owning the asset.

As an example:

Joe is 70 years old and lives alone since his wife passed away 2 years ago. He has two adult children and 5 grandchildren. Like everyone else, the value of his assets have gone down significantly over the last couple of years, although he still has in excess of $8 million of assets. One asset in particular, a strip shopping mall, has decreased in value more than his other assets. The value has decreased from $2 million to $1 million. The mall still generates good income from the leases and, in part, he uses those funds to live on. If Joe exchanged his interest in the mall with his three children for an annuity he could still receive sufficient income to live on, from the annuity payments, and his children would get the asset free of taxes on his death. To make sure there is no gift tax owed, the annuity payments would have to be approximately $95,000 a year. For the rest of his life the children would pay him $95,000 a year. The children would own the strip mall and hopefully could cover the cost of the annuity payments with the lease payments from the mall.

Unfortunately this technique is most successful when the parent does not live as long as expected. It is less advantageous when the parent lives a long and productive life that exceeds their anticipated life expectancy. In some ways it sounds a little bit morbid, having the children win if their parents live a shorter life. However, in many situations the children and the parent like the assurance of knowing that the asset will be owned by the children on the parent's death without estate taxes being owed on that asset.

When establishing annuity payments the property's fair market value, the person's age and an annuity factor obtained from an IRS table published under IRS Code Section 7520 are used to determine the actual payment amounts. The life expectancy of the person receiving payments determines the amount of annuity. Consequently it follows that the older the recipient, the higher the income payments.

After the transfer is made, the assets and future appreciation are removed from the person's taxable estate. As long as the present value of the annuity is roughly equal to the assets' current fair market value, there is no gift tax incurred on the transaction.

How do you go about setting up a Private Annuity? As usual, you should consult your Wealth Preservation professional to ensure that all of the proper steps are taken. There are a few basic requirements you should be aware of: First, when determining the fair market value of the property or asset being transferred, be sure to get an appraisal from a qualified professional. Second, all parties must enter the transaction knowing that the payments must continue for the parent's life regardless of how long that parent survives. Third, the IRS tables must be used to determine the annuity payments.

As with any technique that has estate tax benefits, there are some disadvantages that must be carefully considered. In particular, there are income tax consequences for the individual exchanging their asset for an annuity. You should consult with your Wealth Preservation Professional to see if a Private Annuity is appropriate for your situation.