



# "Giving" Advice



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## Beyond Private Annuities

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By John Churchill

You can kiss the private annuity goodbye. Long favored by the wealthy to avoid huge capital-gains taxes on appreciated real estate (or any other appreciated asset, for that matter), the IRS recently announced that your clients will no longer enjoy a tax-deferral benefit. That said, there are still ways of using private annuities and other similar vehicles to help clients with appreciated assets in estate and tax plans. Of course, some estate planners say they should be avoided since the IRS is aiming to audit taxpayers that use them.

Private annuities involve the sale of an asset—usually real estate, but any asset other than cash qualifies—in exchange for a promise of future annuity payments. Traditionally, the IRS has seen these exchanges as a wash with no taxable gain. A typical scenario would involve wealthy parents entering into one of these arrangements with children. The income tax is then spread out over the lifetime of the annuity payments, and when the parents die, the remainder of the sum goes to the beneficiaries—usually the kids. Particularly troublesome to the IRS was the fact that under the old rules the children could take Mom and Dad's property, sell it to a third party and still avoid income tax on the gains.

According to estate planners, real estate investors can enjoy similar tax benefits in a 1031 exchange, but, because you're exchanging one property for another, you don't actually get the money. (Plus, a cooling real estate market has also dampened the use of the 1031.) The private annuity grew in popularity because taxpayers could reap the same tax-deferral benefits but get paid cash over time from the annuity.



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The "proposals are designed to combat the problem of some taxpayers who have been inappropriately avoiding or deferring gain on the exchange of highly appreciated property for the issuance of annuity contracts," writes the IRS in the regulation proposal.

"The IRS decided it was too good of a deal," says Mike Delgass, an advisor with Sontag Advisory, an independent RIA in Westport, Conn. As a result, any exchanges made after Oct. 18 (with some less attractive exceptions allowed until April 17, 2007) are now taxed immediately on the gain generated by the parents' sale to the children.

But private annuities can still be of some use. While the IRS may have stripped them of their income-tax benefits, private annuities can still offer estate-planning advantages. Delgass offers the example of a father who purchases a piece of property and soon after is diagnosed with cancer. The building, which Dad paid \$5 million for, the full-value, is new enough that capital gains are not a worry. But estate taxes are. If Dad dies with the building in his estate, his heirs will owe \$2.5 million on it. The building can be transferred out of the estate using a private annuity.

But, says Delgass, "As long as Dad lives for at least 18 months after the exchange is made, the property is protected from that whopper of a transfer tax. It's information arbitrage. We know something—in this case that Dad has cancer—that the IRS does not," he says. In short, cases where assets are new and haven't appreciated much, or where the capital gains are minimal because of the underlying tax structure—say, in a family business structured as an S corporation—private annuities are still solid estate-planning tools.

Others say they now should be avoided altogether. Alvin Brown, a tax attorney and principal of Alvin Brown & Associates in Fairfax, Va., says the language used by the IRS in its update about private annuities is "very strong" and anyone considering using one may want to think again. He should know: Brown spent 30 years at the IRS and was a supervisory manager in the Washington office, signing off on IRS tax regulations and interpretations. "Even if you're using them for estate-planning purposes, that's a judgment call on the part of the IRS examiner," he says. Not only that, "Service computers will be looking for 'private annuity' in filings," he says "and, if it comes up, you'll be inviting an audit." (Brown, who says he's tired of the IRS beating up taxpayers, runs a nonprofit forum for citizens to upload and share their experiences with the IRS, called [www.irsforum.org](http://www.irsforum.org), in the hopes of creating more transparency with IRS actions.)

Depending on the desired savings—income taxes, estate taxes or both—there are other options besides private annuities. "Two options to avoid capital gains are charitable remainder trusts and installment sales for a note," says Andrew Katzenstein, a law partner with Katten Muchin Rosenman in Los Angeles. (Katzenstein tackles the private annuity topic in the December issue of *Trusts and Estates*, the sister publication of *Registered Rep.* magazine.) With the charitable remainder trust, parents

get an annuity for life but when they die the remainder of the asset goes to charity, not the kids as with the private annuity. "And the most you can keep is 90 percent of the property. You have to give at least 10 percent to charity," says Katzenstein. There are also grantor trusts, which offer estate-tax savings, as well as self-canceling installment notes, which Katzenstein says "look a lot like private annuities," have "a million advantages" and will likely become the most sought after replacements for those who would have used private annuities.

Whichever route you choose for your clients, these estate planners and others warn interested parties to tread carefully. Says Brown: "Good tax planning should be a conservative endeavor, not an aggressive one."

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