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The Law Offices of KIDWELL & KENT
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Funding Your Buy-Sell Agreement with a Private Annuity

Funding Your Buy-Sell Agreement with a Private Annuity

What is it?

A private annuity is usually used to fund the lifetime purchase of a business interest by a relative or the family business itself. It is an unsecured, open-ended installment sale agreement between the two parties. The buyer promises to make payments of a set amount (the annuity) to the seller for the rest of the seller's life, based on the seller's life expectancy as determined by mortality (actuarial) tables. Unlike an annuity contract purchased from a commercial insurance company, a private annuity is a contract with a private individual or organization. To defer capital gain over the life of the annuity, a private annuity can't be secured by a note or collateral (you can't take your property back if your buyer decides to stop paying).

Caution: *On October 18, 2006, the Treasury and the IRS issued proposed regulations, which significantly change the tax treatment of private annuity payments. Generally, under the proposed regulations, capital gains and losses resulting from an exchange of property for a private annuity contract made after October 18, 2006 (April 18, 2007 for a limited class of exchanges) must be recognized at the time of the exchange, and cannot be deferred over the life of the annuity. These proposed regulations do not apply to payments received from an annuity that was received as part of an exchange made prior to October 18, 2006.*

Example(s): *Say you are a business owner bound under a buy-sell agreement with a specified buyer. Let's assume that under your buy-sell agreement, you can sell your business interest to the buyer named in your agreement when you become ill or want to retire. You are currently in poor health and wish to withdraw from the business. You sell your business interest to the buyer at the fair market value (FMV) price set in the agreement. Instead of paying the purchase price in one lump sum, the buyer promises to pay you a certain amount each year (the annuity) based on your current life expectancy as determined by published mortality tables, current interest rates, and the FMV price.*

Private annuity payments for the sale of your business interest continue for the rest of your life. When you die, the annuity stops. Your estate won't have to include the value of either the business interest or the annuity. You can also choose to spread the payments out over the joint life expectancy of yourself and your spouse. In this case, when you die, payments would continue for the remainder of your spouse's life.

When can it be used?

You want to sell your business during your lifetime and receive income for the rest of your life

If you want to sell your business interest during your lifetime and receive income until you die, then a private annuity may be an appropriate funding method for your buy-sell agreement. Private annuities may be particularly helpful from an estate tax perspective when the seller is in poor health and the buyer is a family member.

Strengths

Useful way to fund buy-sell when seller in poor health, buyer is family member

A private annuity can be useful in funding the lifetime sale of your business interest if you are in poor health and are not likely to live out your life expectancy. You would sell your business interest to your buyer under the buy-sell agreement (ideally, a family member in this case) who would make annuity payments until your death. Your buyer--for instance, your son, daughter, or grandchild--could pay very little for your business interest.

Technical Note: *In general, the rule is that you must have a 50-50 chance of living one year beyond the agreement. The payment amount is calculated based on the life expectancy tables, not your actual life expectancy. If you live for at least 18 months after the private annuity agreement begins, there is generally no challenge by the IRS. Of course, there is always the chance you will outlive all expectations and receive payments from the private annuity stream that exceed the sale price (meaning that the buyer pays a lot more for your interest than expected). See* Questions & Answers *for more information on what happens if you outlive life expectancy.*

Tip: *Arrange for a medical assessment to document the seller's condition as of the date of the buy-sell transfer and annuity*

agreement. Keep the medical documentation for use if the IRS should try to challenge the private annuity.

Caution: *There are different rules in place for terminal illness, which may defeat the purpose of the private annuity. Consult your tax advisor.*

Allows value of business interest to be removed from estate

When you accept a private annuity for the sale of your business interest under the buy-sell agreement, the current value of the business interest is removed from your estate. When you die, the annuity payments stop. Any difference between the annuity payments you received and the actual fair market value of the interest is never paid to you and is therefore not included in the value of your estate.

You receive payments from the sale of your business interest for the rest of your life

When a private annuity is used for buy-sell payment funding, you are promised periodic payments of the sale price plus interest for the rest of your life. This differs from an ordinary installment plan , where you (or your estate) would receive payments for a specific period of time.

May defer capital gains tax

When you sell or transfer your business interest during your lifetime, for instance at your retirement, use of private annuity funding can allow you to spread any capital gain on your sale over your life expectancy as derived from the mortality tables.

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Can be effective funding tool for buy-sell agreement with family member

Sometimes, the primary objective of a buy-sell agreement in a family-owned business is to ensure that the business remains in the family, with less of an emphasis on the sale price or payment method. When the buyer under your buy-sell agreement is a family member, private annuity payments can be an important funding method, allowing the business to stay within the family while minimizing the cash needed at the time of the transfer.

Caution: *It might be tempting to set a low annuity payment by using a long life expectancy period. Be warned, the actual life expectancy of the seller is not normally considered. Life expectancy must generally be derived from the IRS mortality tables, although there have been exceptions which have held up in court.*

Tip: *If you want a longer payment period and you are married, consider choosing the joint life expectancy of you and your spouse for the payment period basis.*

Very simple method

A private annuity can be a simple process. When the time comes to make the purchase, the buyer makes a promise to pay you for the rest of your life and begins the payments to you.

Caution: *If the business itself is the buyer, private annuity payments are generally made from business profits. This means it is possible that you may not get any cash at all if the business can't or won't make payments.*

Tradeoffs

Buyer gets your interest in the business, you might not get all the cash

The buyer takes possession of your interest in the business at the time of sale. Since there can be no security, if the buyer declares bankruptcy or is otherwise unable to make payments, you may not receive full value for your interest. In the case where the business buys your interest, the business is now burdened by the need to make the private annuity payments, thus lowering

the income of the new owner. It is possible that the burden of the private annuity payments might affect the buyer's ability to get outside credit, in turn affecting the ability to expand the business. You bear the risk that the new owner will run the business into the ground, waste the assets, and won't be able to continue your payments.

When you die, payments stop even if the entire sale price hasn't been paid out

The private annuity payments end at your death (unless you have chosen joint life expectancy). If you die before the entire purchase price is paid to you, your estate will not receive the unpaid balance of the purchase price.

Agreement cannot be "secured"

The private annuity cannot be secured by mortgage, collateral, or an escrow account without losing its income tax advantages. This means that if the buyer stops paying you, you don't have property or equipment to which you can take title, or a promissory note to bring to court. If the promise to pay is secured by a mortgage or other type of security, then the gain on the sale of the asset will be immediately and fully taxable to the annuitant. The annuitant will lose the tax benefit of spreading the gain over the full life of the annuity. With a secured annuity, the fully taxable gain would be the present value of the annuity payments minus the seller's adjusted basis in the property.

Caution: *Proposed regulations, generally effective for exchanges made after October 18, 2006, require that any capital gain or loss be recognized at the time of the exchange rather than spread out over the term of the annuity, regardless of whether the private annuity is unsecured.*

You might outlive the person paying the annuity

If the payor of a private annuity is an individual, it is possible that the payor could die before you do. Generally, the payor's estate or heirs would be liable for the continued payments. Unfortunately, your claim against the estate or heirs would be unsecured, and it is possible you might not get your money.

Tip: *A life insurance policy on the payor's life payable to the payor's estate might help to assure your continued annuity payments if the payor dies first. In drafting the buy-sell agreement, a specific provision should be made if this will be the case. Care should be taken--if the beneficiary of the life insurance policy is the estate, you still may not get paid, depending on the estate's debts and their priority.*

Attribution rules apply to family corporation

If the business is a corporation, and shareholders under the buy-sell agreement are related to one another (including spouse, parents of either spouse and their children and their spouses, and any natural objects of the transferor's bounty), the attribution rules (Section 318 of the Internal Revenue Code) must be considered. The attribution rules can affect a shareholder's tax treatment when the corporation is the buyer (stock redemption). In a family corporation, the sale of stock to the business itself usually results in dividend treatment to the redeeming shareholder, part or all of the distribution is first treated as a dividend, any remaining distribution is then received tax-free to the extent of basis, and any distribution still remaining is taxed as capital gains.

Tip: *The attribution rules only apply in the case of a stock redemption and not where the buyer is an individual.*

How to do it

Things to Do Now

Think about how much risk you are willing to accept

If you are confident that your buyer will be able to make payments to you for the rest of your life in exchange for your business interest, using a private annuity to fund the purchase may be appropriate for your buy-sell agreement. However, if you would like more certainty that payment for your business interest will be both available and in full, you may want to look at alternative funding methods such as cash , borrowings , or insurance .

Specify private annuity as the funding method in the terms of the buy-sell agreement

If private annuity payments are the chosen funding method, make sure it is specified in your buy-sell agreement. The principal

amount (or method of determining the principal amount) should be stated in the buy-sell agreement.

Tip: *You might want to include a provision in the agreement that allows the funding method to be changed in the future. If it appears that a private annuity might become less attractive, you might want the flexibility to change to another funding method or to use a combination of methods.*

Things to Do Later

Periodically review the agreement

You and your buy-sell participants should review the agreement on a regular basis, especially if terms specify an annual valuation of the business as a basis for determining the principal amount.

Tip: *If the principal amount is adjustable based on the value of the business and it appears that the value of the business is increasing to levels that might make the amounts of the private annuity payments too large, you might consider adopting funding methods to be used in conjunction with or in place of private annuity payments.*

Review your buyer's finances--are private annuity payments still possible?

As part of the funding arrangement, you should routinely verify that the buyer is still in a position to make the private annuity payments. If the time comes when the use of a private annuity appears less favorable, other funding can be arranged. Ongoing financial reviews can avoid unpleasant surprises later on.

Determine the private annuity payment amount

The amount of the payments will be determined at the time of the business interest transfer. The amount is calculated based on the principal amount, your life expectancy from mortality tables, your age on the transfer date, interest rates at the time of transfer; and present value factors.

Tip: *Consult your tax advisor when setting the private annuity payment amount. There can be expensive* tax consequences *if the amount is not set correctly.*

Tax considerations

Income Tax

Tax effect on the seller: seller may have to recognize gain.

If the value of the business interest has appreciated, you may have to recognize taxable income. The gain can be spread out over your life expectancy as published in the IRS mortality tables.

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Tip: *For certain exchanges of property, the effective date of the proposed regulations is April 18, 2007. In general, this extended effective date applies where the exchange involves an unsecured annuity contract issued by an individual and the property is not sold or disposed of for a two-year period.*

Tax effect on the buyer: payments not deductible.

Private annuity payments are not tax deductible for the buyer of the business interest.

Gift and Estate Tax

Value of business not included in estate

When you transfer your business interest under the buy-sell agreement and begin receiving private annuity payments, your

business interest transfers to the buyer. When you die, the value of the business interest you sold during your lifetime is not included in your estate.

Value of private annuity not included in estate

When you die, the private annuity ceases. There is no value to be included in your estate. There is an exception if you chose the joint life of you and your spouse for the payment term. In this case, if you die first, payments would continue for the rest of your spouse's life. The present value of the future payments to your spouse would be included in your estate but could be structured so as to qualify for the marital deduction.

If payment amounts are too low, gift tax may be incurred

If the amount of the private annuity is less than the amount prescribed by a life expectancy table, or the principal amount is less than the fair market value of the business interest, the IRS could claim that the buyer has paid for property at less than its true value. The difference between the payment amount and the true value set by the IRS would be taxed as a gift. If you intend for the transfer of the business to be partly a gift and partly a private annuity, that is one thing. However, the gift could arise unintentionally through incorrect calculation of the annuity payments. If the value of the business interest sold equals the present value of the private annuity obligation, a gift will not arise. Consult your tax advisor for additional information.

Questions & Answers

What if you live longer than the mortality tables or your doctor's prediction?

Mortality tables are based on insurance company experience and mathematical formulas. It is entirely possible that you may live longer than the time frame estimated when the private annuity begins. Likewise, even though you may be in poor health, you may outlive your doctor's expectations. If you live longer than expected, the buyer of your business interest ends up paying out more than the sale price under the buy-sell agreement. Under the terms of the private annuity, you receive payments from the time you transfer your business interest to the buyer until your death.

What are the tax consequences of outliving the life expectancy used as the basis of the private annuity payments?

With the private annuity, your basis in the exchanged property would be recovered over the life expectancy period. If you live longer than the life expectancy period, the payments received are treated as ordinary income.

How is the private annuity funding method different from the installment payment funding method?

Under both the installment payment and private annuity methods of buy-sell agreement funding, the seller receives payments for the business interest over some period of time. Both can be effective funding methods for the sale of a family business. There are some major differences between the two methods, however, as shown in the following table:

Characteristic	Installment Payments	Private Annuity
Is interest deductible for buyer?	If buyer is a material participant in the business	No
Can payment be secured?	Yes	No
Do payments continue after death of seller?	Yes	No
Is the unpaid balance included in seller's estate?	Yes	No

What is a private annuity trust?

A private annuity trust is a strategy that combines the use of a private annuity with an irrevocable trust. In general terms, you sell

appreciated assets to an irrevocable trust that you establish in return for a private annuity. The irrevocable trust then typically sells the assets, invests the proceeds, and uses the funds to make your annuity payments.

Caution: *The proposed regulations mentioned earlier effectively eliminate private annuity trusts as a viable tax deferral strategy as of October 18, 2006.*

IMPORTANT DISCLOSURES This presentation is not intended to and does not provide investment, tax, legal, or retirement advice or recommendations. The information presented here is not specific to any individual's personal circumstances. To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances. These materials are provided for general information and educational purposes based upon publicly available information from sources believed to be reliable — we cannot assure the accuracy or completeness of these materials. The information in these materials may change at any time and without notice.

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