The Law Offices of Kidwell & Kent
john kidwell
Owner and Managing Partner
9695 C Main Street
703-764-0600
jkidwell@kidwellkent.com
www.kidwellkent.com

Private Annuity: Business Succession Planning

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What is a private annuity?

Sale now offers the promise of future income

A private annuity is the sale of property in exchange for a promise to pay income for the rest of your life. A private annuity differs from a commercial annuity because the buyer purchases the annuity from a private party instead of a financial organization (e.g., an insurance company). You (the seller or annuitant) transfer complete ownership of the property to the other party (the purchaser or obligor). The purchaser in turn promises to make periodic payments to you for a specified period of time. The period of time is either for your life (a single life annuity) or for your life and the life of your spouse (a joint and survivor annuity). A joint and survivor annuity provides payments until the death of the last survivor (i.e., payments continue as long as either the husband or the wife is still alive). A typical private annuity involves the transfer of appreciated property (e.g., a business) from a parent to his or her children.

Offers certain tax advantages

Since a private annuity is a sale and not a gift, it allows you to remove assets from your estate without incurring estate, gift, or generation-skipping transfer tax (GSTT). In addition, because you receive the payments over the span of your lifetime, you spread the gain recognized on the sale, deferring any capital gains tax that may be owed.

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.*

A private annuity can be a great way to preserve a family farm, business, or other asset and free you from the burdens and risks of management. The big catch to this arrangement is that the purchaser's promise to pay must be unsecured if you want to enjoy the tax savings. You may lose your property in the event that the purchaser fails to pay.

What are the advantages of a private annuity?

Avoids estate tax

A private annuity allows you to remove a sizable asset (e.g., your business) from your estate without incurring estate tax. This is because a private annuity is a sale of property for which you receive a fair price (the legal term is "full and adequate consideration") and because the annuity payments cease at your death (in the case of a single life annuity). Property you sell during your life for full and adequate consideration is not included in your taxable estate when you die. So, too, income that ceases at your death is not taxable to your estate.

Caution: *If you have a joint and survivor annuity and income continues to your spouse after your death, the present value of those future payments will be included in your estate for estate tax purposes. However, these payments are also fully deductible under the unlimited marital deduction, so no estate tax will actually be owed.*

Example(s): *Fred is the sole shareholder of a closely held corporation. He works in the business with his two daughters. Fred wants to transfer ownership of the business to his daughters now so that the business will not be in his estate when he dies and thus subject to estate tax. He agrees to sell the business to them, transferring the business to them on the condition that they pay him an annuity for the rest of his life. When Fred dies, neither the stock nor the promised payments will be included in his estate for estate tax purposes.*

Avoids gift tax

A gift is a transfer of property you make for less than full and adequate consideration. Since a private annuity is a sale for full and adequate consideration, it is not a gift and therefore not subject to gift tax.

Caution: *However, if the business is sold for less than the property's fair market value (FMV), the difference constitutes a gift, and gift tax may be owed.*

Example(s): *Auntie Jane owns a small farm in Kansas. She wants to transfer it to her niece Dot but does not want to pay gift tax. Jane draws up an agreement stating that the farm is sold to Dot in return for Dot's promise to pay Jane an income for life. The transaction is a sale at FMV and not subject to gift tax.*

Avoids generation-skipping transfer tax (GSTT)

Generally, gifts you make to your grandchildren--or persons two or more generations below you (so-called skip persons)--are subject to the GSTT (this is in addition to gift tax, not instead of it). However, since a private annuity is a sale and not a gift, GSTT is avoided.

May defer capital gains tax

If you own property with a low tax basis or highly appreciated property, you will recognize a gain when you sell it. Generally, a gain must be reported immediately. However, because you receive the annuity income (or the sale proceeds) over a period of time, you can spread your gain over your life expectancy.

Example(s): *Polly, age 65, owns a cracker factory valued at $100,000. Polly owns the factory for a very low basis ($10,000). Polly wants to retire and sell the factory to her nephew Jack but wants to defer the capital gains tax. So she sells the factory to Jack, and Jack agrees to pay her a $12,119 annuity. Polly pays capital gains tax on a portion of the annuity until her basis is recovered (this is calculated by formula). Once her entire basis is recovered, Polly pays capital gains tax on the entire annuity as she receives it.*

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.*

Turns non-income-producing property into income-producing property

You may own non-income-producing property, such as real estate. You can turn this property into income by selling it in exchange for a private annuity.

Example(s): *Sally, a widow, owns real estate that is currently not producing any income. Her son Jimmy is supporting her. Sally feels that she is a burden to her son and would like financial independence, so she sells the real estate to Jimmy in exchange for lifetime income.*

Provides a fixed lifetime income

If you would like to retire but depend on your salary from the business for most of your income, a private annuity may be a good arrangement for you. You continue to receive periodic payments and yield a higher income than if you sold the business in an outright sale.

Example(s): *Todd Johnson is nearing retirement age and is the majority shareholder of a close corporation. Todd's business does not provide a pension, a profit-sharing plan, or other deferred compensation plan; he depends on his salary for support. Todd wants to retire and transfer his ownership of the business to his son Don but still needs regular income. So Todd sells his stock in the corporation to Don for the FMV of the business, and, in exchange, Don promises to make periodic payments to Todd for the rest of his life.*

Allows you to sell the business to a purchaser who cannot afford to pay

You may want to retire and shift control of your business to a family member or key employee who is capable of managing the business but who lacks the funds to make a lump-sum payment. A private annuity allows the purchaser to make payments over a period of time (perhaps using the income earned in the business).

Example(s): *Sandy Beach owns a small business. He has no heirs but has a key employee who manages the business for him. Sandy would like to see the employee take over the business, but the employee can't afford to buy it in a lump sum. Sandy agrees to sell the business to the employee in return for a promise to pay him income for his life.*

Keeps the business in the family

You may be concerned about your business ending up in the hands of outsiders. Generally, people prefer to transfer their assets to the objects of their natural bounty (their children or other family members). A private annuity is a method that allows you to choose a purchaser that may not otherwise be able to afford to buy the business; therefore, you are not forced to sell to an outsider.

Releases you from the burden of managing the business

A private annuity is a good way to keep your financial resource without the burden of running the day-to-day affairs of the business. When arranging a private annuity, one of your concerns should be whether the other party has the knowledge, skills, and expertise needed to manage the business. You may want to pass on your business to your children or key employees who have worked with you for awhile or someone whom you know to be capable. Selling to someone who may mismanage the business or may otherwise cause the business to fail may put your future annuity payments in jeopardy (especially if the other party has no other financial resource).

Avoids probate

Assets that have been transferred before you die do not pass through probate (the court-supervised process of administering your will). The probate process can be quite lengthy and costly. A private annuity avoids probate and saves your estate from paying probate costs.

What are the tradeoffs?

You may lose the property if the purchaser fails to pay

In order to enjoy the tax savings, you must transfer the property without any right to collateralize any of the purchaser's property in the event the purchaser fails to make the agreed-upon periodic payments. The IRS sees a security interest as a retained financial interest in the property. This causes any gain to be recognized immediately and may cause the transfer to be a taxable gift, subject to GSTT and/or gift and estate tax. This creates a tremendous risk for you in the financial safety of the purchaser. If the purchaser mismanages the business, the business otherwise fails, or the purchaser suffers some misfortune, your payments may stop. Your only recourse may be to take the purchaser to court for defaulting on the agreement. If the purchaser files for bankruptcy, secured creditors will be paid before you. In the end, you may get nothing.

Tip: *Since your interest must be unsecured, one of your biggest concerns should be whether the purchaser has the financial ability to make the promised payments to you. You should carefully consider the financial, emotional, and domestic relations status of the party with whom you are dealing. Do not enter into an agreement unless you feel comfortable with these aspects.*

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, regardless of whether the private annuity is unsecured.*

You may die unexpectedly

When you arrange a private annuity, you transfer total and complete ownership of the business to the purchaser and retain no interest whatsoever. In addition, the purchaser's obligation to make payments ends when you die. What happens if you die soon after making the deal? The purchaser stops making payments and gets the business for less than expected. Therefore, your estate (your spouse and family) gets less than the real value of the business.

Example(s): *Steve owns a car dealership but hates the business and wants out. Steve's brother Jack wants the dealership but has no money, so the two brothers agree to a private annuity arrangement. Steve has a wife and several small children. Two days after Steve receives the first annuity payment, he is killed in a car crash. Jack ceases to make any further annuity payments, keeping the dealership free and clear for a fraction of its value. Meanwhile, Steve's family loses a significant asset that they would have had if the private annuity had not been arranged. Jack and Steve's families are no longer on speaking terms.*

You may live longer than expected

Another risk of a private annuity is that you may live beyond your expected life span. If you outlive your life expectancy, the purchaser's obligation to pay is not released, and payments still continue. The result of this is threefold:

- The purchaser overpays for the business: The FMV of the business is spread over the term of your life expectancy. If you live longer than expected, the purchaser ends up paying more than the FMV or overpays for the business.

- You recognize income: Income you receive during your life expectancy period is considered sale proceeds (part return of basis, part interest). However, payments you receive after you have outlived your life expectancy (in effect after the property is paid for) are considered earned income. That income will be taxed to you as ordinary income for income tax purposes.
- The benefit of removing the asset from the estate is minimal.

Caution: *The part of the annuity that is allocated as interest earned by the seller is not treated as interest paid by the purchaser. The purchaser can't deduct this amount as interest on his or her income tax return. The purchaser must treat the entire annuity payment as basis for the property.*

You give up control of the property

Since you can retain no interest in the property, you give up control of that property, totally and absolutely. Do not consider this strategy if you are not ready to hand over the reins of the business to someone else.

It can be costly

Substantial legal costs and other expenses may be incurred in connection with a private annuity. You will need to hire an attorney (which is never cheap) to advise you of the tax rules, draft an agreement, and perhaps set up a trust. You should also hire an expert appraiser to properly value the property you are selling. You may also want to hire a tax accountant to accurately calculate the taxes.

How is a private annuity created?

Any type of property can be used

A private annuity can be arranged using any type of property (e.g., a home, real estate, stocks, or a business interest).

Determine fair market value

The first thing you must do is determine the FMV of the property you are selling. This is important, because you need an accurate value to know that you are getting a fair price for your property. In addition, the IRS may challenge the value if it is not reasonable. If the IRS is successful, (1) the transfer may be deemed a gift (or partial gift) and therefore subject to GSTT and/or estate and gift tax, and/or (2) you may have to report a larger gain on the transaction.

FMV means the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. In other words, it's what property would sell for on the open market. Valuing property can be a complex and highly speculative process. To prevent a dispute with the IRS and to keep the court from becoming involved in the valuation question, you should use care and thoroughness in arriving at a reasonable value. Use published references (newspapers, or valuation tables issued by IRS) when possible. Refer to IRS regulations and rulings concerning how property is to be valued for tax purposes. You may need or want to use qualified experts and appraisers for certain property and create documentation to back up the values you establish, especially for hard-to-value assets (e.g., real estate and stock in closely held companies).

Tip: *An expert appraiser can be found in the yellow pages or by seeking referrals from banks, financial planners, or real estate brokers. Be sure to check the appraiser's credentials for experience in valuing property for income and estate tax purposes.*

Calculate annuity using IRS annuities for life actuarial table

Once the FMV has been established, you need to look up the applicable annuity factor on the annuities for life tables issued by the IRS. These tables are based on your life expectancy and are classified by single life or two life and by the federal discount rate. For example, say you're making the agreement for a single life annuity in a month when the federal discount rate is 3 percent. You refer to the table labeled single life, 3 percent and look up your current age. Say you are 65. The factor is 12.9434. You then divide the FMV of the property by this factor. If, for example, the FMV is $100,000, the amount of the annuity payment (annual payments with payments at end of period) is $7,726 ($100,000 ÷ 12.9434).

Ascertain ability of purchaser to make payments

If the purchaser has sufficient independent income, then any of your assets can be sold with relative confidence that the purchaser can make the payments. But if the purchaser has little or no income, be sure that the property you are selling produces sufficient income to make the annuity payments. If this is not possible, at least be sure that the property is of a type that can be easily sold or borrowed against.

Caution: *The purchaser should not be a person who regularly engages in issuing private annuities. This may cause the IRS to classify the annuity as a commercial annuity, and the benefits of the private annuity will be lost. The purchaser should be someone who is the natural object of your bounty (e.g., your children or other family members).*

Draft a written agreement

Once the details of the arrangement are agreed upon, put it in writing. It is recommended that you hire an attorney to draft the agreement. This is especially important because your interest must be unsecured. The terms of the agreement should be clear and easy to prove in case the purchaser defaults and you wind up in court. (Of course, you don't anticipate that this will happen, but an ounce of prevention is worth a pound of cure.)

Transfer must be complete and absolute

Transfer complete and absolute ownership of the property to the purchaser. It is extremely important that the purchaser's promise be unsecured; otherwise, a taxable event will occur immediately upon the signing of the agreement. This means that you cannot retain a pledge, mortgage, lien, or any security interest in the property. Make sure the agreement clearly states that the promise is unsecured and ensure that a security agreement (a UCC form) is not executed or filed.

Report GSTT and/or gift tax, if necessary

If the annuity is purchased for less than the property's FMV, the difference is a taxable gift. If the difference is greater than the annual gift tax exclusion, you must file an annual gift tax return and pay any gift tax that may be owed. In addition, if the gift is made to a skip person and the difference is greater than the GSTT annual exclusion, you must file an annual GSTT return and pay any GSTT tax that may be owed.

File annual income tax returns

You will have to file an annual income tax return for each year you receive the annuity payment. The annuity payments can include return of capital, gain, and ordinary income. These amounts are calculated by formula.

What are the tax consequences?

Income Tax

Each annuity payment is treated as part tax-free return of basis, part capital gain, and part ordinary income until your entire basis is recovered. Once your basis is recovered, the entire annuity is treated as part capital gain and part ordinary income until you have surpassed your life expectancy. Payments received after your life expectancy are taxed as ordinary income.

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 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.*

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.*

Estate Tax

Neither the value of the property transferred nor the value of the promised payment is subject to estate tax.

Gift Tax

Generally, the value of the property transferred is not subject to gift tax. To the extent that the transfer is for less than FMV, the difference is a taxable gift, subject to gift tax. Generally, the value of the property transferred is not subject to the GSTT. To the extent that the transfer is for less than FMV, the difference is a taxable gift, subject to GSTT.

Questions & Answers

What happens if the seller's death is imminent?

Since a private annuity is computed using mortality tables, a seller who is terminally ill is treated differently. The life expectancy tables issued by the IRS may not be used if there is at least a 50 percent chance that the seller will die within one year from the date the annuity is arranged. If this is the case, special factors provided by the IRS (as opposed to the annuities for life tables) will need to be used.

Tip: *If the seller lives longer than 18 months after the annuity is arranged, he or she will be presumed not to have been terminally ill and the IRS life expectancy tables will apply.*

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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