



The National Association of Financial and Estate Planning

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MEMORANDUM

Date: March 21, 2006

To: NAFEP Members And Interested Parties

Subject: NAFEP Rebuttal of the Article, Stupid Private Annuity Tricks By Joseph Petrucelli, JD, LLM

The following article regarding private annuities has been widely circulated by the author. While the article has a ring of authority, NAFEP rebuttals below point out what we believe are statements and positions which range from very misleading to glaring errors and misunderstandings of the author.

The NAFEP rebuttal comments are written in bold blue text.

Mike Janko, President
NAFEP

Stupid Private Annuity Tricks

[Forward: When carefully planned and properly used, private annuities can be a very powerful tax deferral and estate planning tool. 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 described 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. ~ Jay Adkisson]

There are some unscrupulous promoters, but many of the "stupid tricks" listed below are not stupid at all. The writer simply doesn't have sufficient command of the subject in our opinion. NAFEP

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.

I agree that there is a point of no return in being able to convert a straight real estate sale to a private annuity transaction. But we have researched this thoroughly, know where that point is, and don't plan to cross it. There may be a problem here with practitioners who are not connected to NAFEP, but we have seen little evidence of it. I think most half way reasonable people intuitively know what they can and cannot do in this regard. NAFEP

2. 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.

I challenge the validity of this argument completely. Petrucelli misunderstands PAT mechanics and the IRS treatment of the transaction. The PAT annuitant does not replace real estate with a commercial annuity in any reasonably well structured PAT transaction. The PAT annuitant receives a private annuity contract in exchange for the real estate, period, end of story. The PAT annuitant is not allowed to have any connection with the investments in the trust, and no trust investment is ever treated as part of the exchange between the PAT and the PAT annuitant. The private annuity payments are designed to have no connection to the income, investments and/or investment performance of the trust.

For Petrucelli's argument to be valid, the PAT annuitant would have to be the owner of the trust, and maybe that is how he thinks PATs are designed. But no reasonable PAT practitioner would ever design a PAT where the PAT annuitant had any incidents of ownership in the trust. That violates PAT design and rules 101. The trust is always designed to be an independent taxpayer, non-grantor trust, with no ownership or control of the PAT by the annuitant. The non-grantor trust will be both the owner and the beneficiary of the commercial annuity and will manage AND CONTROL the commercial annuity the same as any other investment which the trust might choose to enter into. With the lack of any tie-in between the private annuity contract and the trust investments, and the absence of any control or incidences of ownership over the trust by the PAT annuitant, there is no

reasonable possibility the PAT annuitant would be viewed by the IRS as having traded his property for the commercial annuity. And, there are no court rulings, IRS rulings or even any IRS audit experience we are aware of which support Petrucelli's position.

If Petrucelli's argument were valid, then it would extend to any other investment which the PAT made. That is, if the PAT purchased and owned a simple stock portfolio, by Petrucelli's reasoning you would have to conclude that the PAT annuitant exchanged his real estate for a stock portfolio. You would have to go on to conclude that no investment could be made which was legal, so why would Petrucelli even bother to single out commercial annuities as questionable investments for the trust. But in reality, the annuitant receives a private annuity contract for his property and there is no other implication or tie to the trust, as Petrucelli suggests, from the initial property exchange in a reasonably well structured PAT.

If either the private annuity trust or the purchase of a commercial annuity by the PAT was a serious problem for the IRS, they would have listed it in Notice 2004-67. This notice is the IRS' highly publicized, black list of questionable tax vehicles and strategies. The items on this black list are referred to as "listed transactions", and this document is at the heart of what Circular 230 is all about. But there is no mention of the private annuity on the Notice, neither the PAT nor the commercial annuity investment are a "listed transaction", and this list has been years in the making. The IRS is extremely well acquainted with the existence of PATs, having written relevant letter rulings and having been a defendant in numerous cases, so leaving PATs off Notice 2004-67 was no oversight. The IRS is no threat to reasonable PAT practices. NAFEP.

Additionally, certain provisions of the Code may result in inclusion of the commercial annuity in the estate of the taxpayer. **I challenge this. I do not believe this to be possible, based on my response above (Mike Janko, NAFEP).**

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 70 ½. 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.

Petrucelli is not thinking this through. The reason that the private annuity trust invests in a commercial annuity or anything else is to produce sufficient growth and income to meet the private annuity payment obligation. You wouldn't pick an investment if you did not think it would perform in this manner, with or without deferral of the private annuity. There is no rationale to conclude that increases or growth in the private annuity, due to deferral, could not be reasonably met by increases (growth and/or income) in a commercial annuity of at least an equal amount over that same time period. In fact, good financial planners make this happen every day. This is all very fundamental, financial planning 101. NAFEP.

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.

This argument doesn't make sense. Private annuity transactions are not set up for gifting. The private annuity issued by the transferee (trust) in exchange for the property received from the transferor (annuitant) is essentially a buy-sell agreement, not a gift. The transferee (trust) pays full, fair market value for the property. The form of payment is the private annuity contract. To the extent that fair market value is paid in the private annuity, there can be no gift. So there is no reason to address a gift intent or gift tax as Petrucelli raised here. NAFEP.

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.

Not true, not a valid concern.

First: Of course if the annuitant has existing creditors and/or judgments breathing down his neck, a PAT transaction could be treated as a fraudulent transfer (though this has absolutely nothing to do with gift taxes, as Petrucelli seems to be saying). But we have never heard of a client attempting to use a PAT for that purpose, nor have we seen any promotion of PATs for this purpose. All the clients we know about have set up their PATs for capital gains deferral and/or estate tax planning. And, no reasonable practitioner would attempt to help a client with a fraudulent transfer.

Second: The IRS and tax courts have always characterized the excess of FMV over PV as a gift, with never any other tax treatment or result. We can easily produce the cites and rulings to back this up if necessary, but this is so fundamental to PAT design and tax treatment that we aren't bothering to provide the proof here, and we are very surprised that Petrucelli thinks otherwise. NAFEP.

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.

As for commercial annuity investment by the trust, we already responded to that in topic/paragraph 2 above. As to legal opinions, private letter rulings and Circular 230, there already is an on-point private letter ruling, several decisive court cases and some Treasury Regulation thrown in to provide ample support of the PAT concept*. The abundance of authority is widely recognized by major reference publishers, Big 4 accounting firms, the American Institute of Certified Estate Planners (AICPA) and highly respected tax authors and practitioners all over the country. Circular 230 is a detail, but nothing more, and not a problem in a reasonable practice (see my Circular 230 comments in topic/paragraph no 2 above).

Based on the comments in the foregoing paragraph and the citations below, seeking a private letter ruling is a waste of time. This would result in nothing but a disservice to clients who don't want to wait a year or two on a bureaucratic process, who don't need the misleading advice and who don't need the unnecessary expense of requesting the ruling. And note that the IRS has already issued a private letter ruling which has direct bearing (yellow highlighted in the list below).

*** As just the bear minimum of legal authority we are able to cite, consider these cases and rulings:**

Important Court Cases, Integration of Private Annuities With Trusts

- **Stern v. COMM., 54 AFTR 2d 84-6412, Code Sec(s) 677; 72, (CA9), 11/15/1984**
- **Lafargue V. Comm., Cite as 50 AFTR 2d 82-5944 (689 F.2d 845), 10/06/1982 , Code Sec(s) 72**
- **Benson v. Commissioner, 80 TC 789.**
- **Estate of Benjamin Shapiro, TC Memo 1993-483**

Important IRS Rulings

- **Rev Ruling 55-119**
- **Rev Ruling 69-74**
- **General Counsel Memo GCM-39503**
- **Rev. Rul. 77-454, 1977-2 CB 351**
- **PLR 200352001, 12/24/2003, IRC SEC(S). 1275**

Miscellaneous Authority, Re: Integration of Private Annuities With Trusts

- **Treasury Regulation 25.7520-3(b) from the U.S. Department of Treasury was specifically written to value a certain characteristic of private annuities issued by a trust. This is a strong statement of the recognition of the private annuity trust concept. (Note: The formulas and concepts of this Regulation were invalidated by the above cited, Shapiro case, as they should have been. But Shapiro clearly upheld the private annuity trust concept itself.)**
- **Charitable remainder trusts (CRTs) and grantor retained annuity trusts (GRATs) are two other examples of private annuities issued by a trust. Both CRTs and GRATs are universally recognized as legal, and are well covered by tax law, rulings, etc. Especially in the case of the CRT, the concept and the rules are very similar to those of private annuity trusts. There is little logic in negating the validity of a private annuity transaction with a private annuity trust, and then widely accept the validity of doing private annuity transactions with CRTs and GRATs.**

Other Important IRS Rulings

- **Rev Ruling 55-119**
- **Rev Ruling 69-74**
- **General Counsel Memo GCM-39503**

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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 non-grantor 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.

I don't agree with the underlined part of this statement. A grantor trust is not recognized at all as an independent entity in tax law. A grantor trust is a mere extension of the grantor himself. There could be no difference in tax recognition between converting a funded grantor trust to a non-grantor trust state, and in simply placing the same property in a non-grantor trust. This isn't a standard practice anyway (grantor trust conversion to non-grantor), so there really isn't a problem to deal with. And, if Petrucelli questions the legitimacy of a private annuity trust, see my answer to topic/paragraph 4 above. NAFEP.

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.

That problem could easily be offset by the property being out of the taxable estate of the annuitant. That is, the estate taxes which are saved in the annuitant's estate could easily be as much as or more than the capital gains that would be realized. Further, in actual practice this is rarely a problem. NAFEP.

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.

There is no problem here. The phenomenon of increasing the size of private annuity payments from the effects of deferral is simple economics and investment planning math. The very thing which causes the private annuity to have growth in value (deferral), causes exactly the same thing for the investments of the trust. That is, the trust's investments will also grow with just routine investment planning. Petrucelli is simply in denial about basic economics and math. Also, this issue was raised in topic/paragraph no. 3 above, and responded to there. NAFEP.

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.

Agreed, though in a reasonable practice this is not a problem. NAFEP.

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.

Agreed, though in a reasonable practice this is not a problem. NAFEP.

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.

Agreed that the private annuity payment money comes back into the taxable estate, but in a reasonable practice this is not a problem. NAFEP.

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.

Agreed, though we have never seen such a design, in a reasonable practice this is not a problem. Bringing this issue up is likely to mislead clients to believe this is a real problem for PATs, when it really isn't. NAFEP.

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.

Living too long, making too much money in the process, even if I have to pay some extra taxes is not a problem! God, please do this to me. Seriously, that is one of at least a dozen good reasons to structure private annuities in a trust. The trust beneficiaries, usually the heirs of the PAT annuitant, don't get hurt from this "problem". The beneficiaries don't have to pay the money personally which the trust owes, and they still get whatever the PAT annuitant has left in his personal estate, via the annuitant's traditional estate planning (will, intestacy, trust, etc). NAFEP.

13. Not asset protecting 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.

Agreed, completely. NAFEP.

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.

Well, that approach is more or less private annuity calculation planning 101. NAFEP.

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.

This is basically the same argument made in topic/paragraph no. 3 above, and which I answered there. NAFEP.

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.

Since I have never heard of a "private placement annuity", or have heard but forgotten, there cannot be much of this practice going on. Seems odd that Petrucelli is so negative on the well known, well accepted and widely practiced PAT concept, but is here touting something which is really offbeat. NAFEP.

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 "re-valued" 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.

I don't have a definite opinion on whether such an exchange is legal, but I doubt it is. In a reasonable practice, this would not be attempted anyway. Bringing this issue up is likely to mislead clients to believe this is a real problem for PATs, when it really isn't. NAFEP.