



Private Annuity Trusts Can Help Defer Taxes

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By **RAY A. SMITH** Special to RealEstateJournal.com

Question: I'm interested in private annuity trusts, which you wrote about previously as vehicles that can help real-estate owners defer capital-gains taxes on property sales. If a real-estate owner can sell property to a private annuity trust and the trust can turn around and sell to a third party, how does one get around the rule in the Internal Revenue Code, section 453(e) that says: "If any person disposes of property to a related person and before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property, then ... the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition" ?

Margaret, Louisville, Ky.

Answer: First, let's decipher the Internal Revenue Code. If a person sells a property to a related person and then that related person sells it to a third party before the original seller gets proceeds from the first sale, then the proceeds the related person gets should be treated, capital-gains tax wise, as received by the original seller. So if you sell a property to Mr. Smith and Mr. Smith doesn't pay you all the proceeds all at once, but in installments, and Mr. Smith sells the property to Mrs. Jones before you receive all the proceeds from your sale to Mr. Smith, the proceeds Mr. Smith receives from Mrs. Jones would be considered capital gains on your original sale so you would owe capital-gains tax.

According to Richard T. Williamson, author of "Selling Real Estate Without Paying Taxes" (Dearborn Trade Publishing, 2003), the answer to your question is: You don't have to get around the rule. The IRS rule applies specifically to installment sales, where the owner sells a property on a long-term payment plan with the property as security for the debt. Installment sales stretch out capital-gains taxes so the seller doesn't incur a huge upfront tax bill.

A private annuity trust, on the other hand, is a trust in which the property owner transfers ownership of the property to a trust before completing a sale to a buyer. The trust pays the owner for the property, not in cash, but with a special payment contract called a private annuity that stipulates that the trust will make payments to the owner for the rest of his or her life - essentially in installments. The trust often names the property owner's children as beneficiaries. The trust can then sell the property to the buyer, getting cash for the property.

In a normal sale, the seller would immediately pay capital-gains tax on the full value of the property. Since the private annuity contract calls for payments to be made over the seller's life, the seller is taxed on payments only when they are received, instead of all upfront.

So if you transferred ownership of a property to the trust and the trust sells it to Mr. Smith, proceeds from the sale go to the trust, which can use the proceeds to make investments. The trust is required to make fixed payments to the investor for the rest of his or her life. The amount of the payments is determined by Internal Revenue Service life-expectancy tables.

Even if the rule were a consideration or a concern when using a private annuity trust, "the IRS definition of related party would not apply because of the way private annuity trusts are structured," says Mr. Williamson, an estate and capital-gains tax-planning attorney in Long Beach, Calif. With a private annuity trust, he explains, the property owner is the originator of the trust but when the property is transferred, he becomes an annuitant or creditor, not a beneficiary or fiduciary. The structure of trusts within the rule's definition of related party are those in which the property owner is also a beneficiary or a trustee, which is not the case in private annuity trusts.

The National Association of Financial & Estate Planning in Salt Lake City can help you understand the ins and outs of private annuity trusts. Technical and legal information, for instance, is available in an association publication called "Private Annuity Legal Package." For more information, visit the association's Web site, www.nafep.com, or phone: 801-266-9900.

Mr. Smith is a staff reporter for The Wall Street Journal. His "Building Value Q & A" column appears each month exclusively on RealEstateJournal.

How to Sell High And Keep Taxes At a Distance

BY RAY A. SMITH
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Want to cash out of a property at today's high prices, yet worried about a hefty capital-gains tax bill?

Some creative selling strategies allow one to do the former and defer the latter.

One such strategy is the installment sale, in which the owner sells the property on a long-term payment plan. In this scenario, the buyer pays the cost of the property in regular installments, with interest. The installment sale allows the seller to stretch out capital gains taxes, typically over a five-year period, so the seller doesn't have a huge upfront tax bill.

A lesser-known strategy is using a private annuity trust. This is not to be confused with an annuity issued by an insurance company. Rather, it is a trust in which the property owner can transfer ownership of the property (often to his or her children) before completing a sale to a buyer. The trust pays the owner for the property, not in cash, but with a special payment contract called a private annuity that stipulates that payments from the sale go to the owner for the rest of his or her life, essentially in installments.

The trust then sells the property to the buyer, getting cash for the property. In a normal sale, the seller would immediately pay capital-gains tax on the full value of the property. Since the private annuity contract calls for payments to be made in installments over the seller's life, the seller is only taxed on payments when they are received, instead of all upfront. The amount of payments is determined by Internal Revenue Service life-expectancy tables.

Financial planners are increasingly recommending these strategies to clients considering selling their properties because prices have risen dramatically over the past three years.

Buyers, too, can generally benefit, saving costs and time associated with taking out a new mortgage from a lender.

There are risks for sellers. In both methods, "the seller doesn't get the entire purchase price right away so the seller needs to be comfortable deferring income and have other sources of assets or income," says Michael A. Dubis, a certified financial planner in Madison, Wis.

An additional risk with an installment sale is "rather than getting the full amount upfront and not worrying about how the new owner treats the property, the seller who takes an installment note keeps the property as collateral," notes Joseph Murtagh, a financial planner in Goshen, N.Y. "If there is a default, they have to take back the property and by then it may be worth less than when they sold it" if the new owner didn't take good care of the property. With a private annuity trust, the trustee could make bad investment decisions or commit fraud, jeopardizing the seller's payments.

While both methods appear similar, there are significant differences. A seller using a private annuity contract, for example, can postpone when payments from the trust begin, and no capital-gains taxes will be due during that time. By contrast, payments under an installment sale must begin immediately.

Sellers using the private annuity contract can also defer taxes known as depreciation recapture, in which the IRS recaptures depreciation the owner had previously received deductions for. With an installment sale, the recapture tax has to be paid immediately, notes Scott A. Leonard, a certified financial planner based in Redondo Beach, Calif.

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Slow-Motion Selling

Installment sales and private annuity trusts are methods of selling commercial property that allow owners to defer capital-gains taxes by collecting proceeds over time instead of all at once. Here are some tips on how to go about pursuing these strategies.

Tips on Installment Sales:

- Make sure you know the creditworthiness and the personal financial status of the buyer. Ask for bank statements and other personal financial records and perform a credit check.
- Make sure the property will produce enough income going forward so that the buyer won't have any trouble paying you.
- Make sure the interest rate you charge the buyer is competitive with current market rates.
- Get a down payment of at least 20% upfront as a way to give yourself some protective cushion in the event the buyer defaults and you have to conduct a foreclosure. That payment could help you cover expenses resulting from the foreclosure.

Tips on Private Annuity Trust:

- Make sure you identify a responsible person or persons to be the trustees. You want a trustee that's going to make smart investments with the proceeds from the sale and won't squander the gains.
- If you have other sources of income and don't need the payments from the property sale right away, then you may want to choose deferral. Payments must begin by age 70.
- Don't make the annuity the only or a major source of your overall income or net worth. You can't pull a lump sum of money out of the annuity so you want to have other means of coming up with cash in a crunch.
- There is some flexibility in the payment stream. The trust can lend money to the annuity holder, or issue more than one annuity to the holder from the start. The annuity holder can also borrow from a bank and pledge the annuity payment stream to receive a loan.

Sources: Joseph Murtagh, Scott A. Leonard, certified financial planners, and [the National Association of Financial and Estate Planning](#).

Private Annuity Trusts: Questions and Answers

BY RAY A. SMITH
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The Nov. 19 Building Value column discussed creative ways investors could defer capital-gains tax bills from the sale of their properties. Numerous readers wrote in asking for more information about one such strategy: private annuity trusts.

Under this plan, the owner of commercial or residential property transfers ownership to a trustee prior to the sale of the property. The trust pays the seller with a special payment contract called a private annuity that stipulates that payments from the sale of the property go to the owner for the rest of his or her life. The trustee then sells the property to the buyer, getting cash for the property and holding it in a trust. The trustee also can invest the money held in trust.

Since the private annuity contract calls for payments to be made in installments over the seller's life, the seller is only taxed on payments when they are received, rather than upfront. The amount of payments is determined by Internal Revenue Service life-expectancy tables.

Here are some of the specific things readers inquired about, along with the responses of financial planners. The accompanying chart explains how the payments to the annuity holder are taxed.

How Long Can I Defer Payment?

Annuity holders can defer payments for years after the sale but they must begin by age 70½. Once payments begin, the annuity holder will receive payments for as long as he or she lives.

Who Can be a Trustee? The seller -- or private annuity holder -- can't be the trustee or have any direct control over the trust. The trustee may be any adult, including an adult child, who is not claimed as a dependent. Even the annuity

holder's accountant, attorney, financial adviser, family friend or relative outside of the immediate family can be a trustee, according to the National Association of Financial and Estate Planning. What's more, you can have one trustee or two co-trustees.

How Much Do I Get? The annuity holder's income is fixed, meaning that he or she receives a fixed payment amount determined by the private annuity's face value, the annuity holder's age and the Internal Revenue Service's stipulated interest rate. The holder can't receive more than his or her fixed payments, regardless of what the trust earns through investments made with the proceeds. Whatever extra the trust earns on investments has to be held for the trust beneficiaries or paid to them. Scott A. Leonard, a certified financial planner in Redondo Beach, Calif., says that since it's assumed some of the proceeds will be invested, part of the payments from the annuity will be taxed as income.

What About Other Taxes? Sellers using the private annuity also can defer taxes known as depreciation recapture, in which the IRS recaptures depreciation the owner had previously received deductions for. For example, if depreciation recapture on the sale of a \$500,000 house comes out to \$100,000, and life expectancy of the annuity holder is 25 years, that would amount to \$4,000 a year in depreciation recapture taxes, according to Mr. Leonard.

What Properties Count? Some readers wondered whether a rented-out single-family home could be sold with the owner using a private annuity. The answer is yes. Annuities can be used for a rental property and a primary residence.

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Paying the Piper

Private annuity trusts allow owners of real estate to defer paying capital gains when they sell property. Here's how the payments to the annuity holder are taxed.

- First, the annuity holder has a cost basis in his or her property.
- A proportionate share of that basis is returned to the holder each year in the form of an annual payment. That share is tax free to the annuity holder.
- Another part of each year's payment will be a proportionate share of the capital gains realized from the sale. That portion will be taxed at capital-gains rates.
- So if the annuity holder has a 15-year-life expectancy, he or she will receive 1/15th of his or her basis and 1/15th of the capital gains each year.
- The last part of the payment is ordinary income, and is taxed accordingly, at ordinary income tax rates. The reason the annuity holder receives ordinary income is that the private annuity always earns interest on the unpaid balance. Interest is paid out each year on top of the basis and capital-gains portions.
- The entire value of the property is removed from the taxable estate of the annuity holder. When the holder dies, the payments to him or her cease and the annuity becomes null and void, leaving nothing in the estate. Whatever is left in the trust will pass to the beneficiaries completely free of estate and gift taxes.

Source: The National Association of Financial and Estate Planning