



The National Association of Financial and Estate Planning

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## RESEARCH MEMO: Advantages Of A Private Annuity Over A 1031 Exchange ©

The NAFEP private annuity trust (PAT) is an excellent alternative to and has many distinct advantages over 1031 exchanges. Both 1031 exchanges and PATs allow you to sell appreciated real estate and defer the capital gains and depreciation recapture taxes. However, there is a catch with the 1031: The seller must re-invest 100% of the sales proceeds into a replacement (like kind) property or properties of equal or greater value to receive the benefit of full tax deferral. The property owner is still in the real estate business and hasn't cashed out at all with a 1031 exchange. However, a PAT allows you to truly sell the property, get out of real estate if you desire, and receive a lifetime income from the property you sold. Other 1031 problems are:

- Within 45 days of the close of the 1031 escrow, the seller must identify his/her replacement properties, The acquisition of these properties must begin within 180 days of the close of escrow of the sold, 1031 property. If the buyer does not identify and acquire a replacement property between the specified time periods, he/she will be responsible for the payment of all capital gains and depreciation recapture taxes in the property which was sold.
- Often there are differences between the fair market values in the properties which are being exchanged, resulting in one party or the other having to pay "boot" to adjust for the difference. Under the 1031 exchange rules, an exchanger of property must recognize gain, up to the total of the amount of money and fair market value of the other property received. If an exchanger is trading a \$1,000,000 property for an \$800,000 property, one common result is that the exchanger will receive the \$800,000 property and \$200,000 in cash, which is the "boot". Since the cash boot is not like kind property, is not real estate, it doesn't qualify for deferral. So all of the boot must be treated as immediate and taxable gain to the exchanger.
- The amount of any liability, debt or mortgage which is assumed by one party in the exchange is treated as money paid to the other party. The party being relieved of the liability, debt or mortgage is treated as having received boot or cash in the amount of the debt which was relieved or given to the other party. This relief of the debt is not a like kind exchange and the full amount is immediately taxable.
- Finally, many property owners want to trade down, exchange for a lower priced property. If they do a 1031 exchange for a lower priced property, they must pay taxes on the proportionate share of capital gains in the difference between the prices of the two properties. A PAT can solve this as follows: An owner wants to trade down from a \$1,000,000 property to a \$500,000 property. Normally this would required the owner to recognize one half of all gains and depreciation recapture if he/she does nothing more than this exchange. But, if half of the value of the \$1,000,000 property is sold via a PAT, and the other half is traded in a 1031 exchange, the owner receives deferral on the entire \$1,000,000.

Besides the above listed problems with 1031 exchanges, there are several distinct advantages which a PAT has over a 1031 Exchange:

- A PAT eliminates estate and gift taxes on the property which goes into the PAT, thus shifting more wealth to the heirs of the property owner (the beneficiaries of the PAT).
- Many analysts believe that today's real estate markets have peaked, that many areas of the country are experiencing a real estate bubble. A PAT will "lock in" today's market values. For example, if an owner has property worth \$2 million dollars today, and the real estate markets decline, that same property may drop to \$1.5 million or less in value. Where a PAT locks in today's high values, a 1031 exchange merely *shifts* market value risks to a different property.
- All assets that are in a PAT are considered outside the seller's estate. In the event of a lawsuit against any party to the PAT, including the original property owner who created the PAT, the trust assets not attachable. Depending on circumstances, the PAT income may be at risk if the PAT creator is successfully sued, but his/her heirs still have the PAT assets intact for their benefit. With a 1031 exchange the owner still bears the full risk of losing the property in a lawsuit.
- Owning and managing a property can be very demanding. Some property owners are looking to fully or partially exit the real estate market. The PAT allows owners to retire, relax, reduce lawsuit risks, lock in today's property values and receive a monthly income for the rest of their lives with none of the worries of everyday management. A 1031 exchange the owner still has to accept the liabilities of property ownership and manage the property and its tenants.