



## Private Annuity Trusts

### The Private Annuity Trust (PAT) Alternative

- Investors have traditionally used a variety of methods to try to limit or defer their tax consequences. Tenants In Common (TICs), 1031 Exchanges, Installment Sales, Self Canceling Notes and Charitable Remainder Trusts (CRTs) have been the more publicized methods in the past. However, since the 1980s, tax and estate planning professionals have increasingly turned to a little known strategy called a Private Annuity Trust (PAT). PATs are appealing because they may provide significant income and estate tax relief along with other benefits including:
  - No capital gains taxes, depreciation recapture taxes or state taxes owed upon the sale of your asset.
  - No estate tax imposed upon the taxpayer's death for assets inside the PAT.
  - The creation of an income stream for life or joint lives.

### How a Private Annuity Trust Is Structured

- A PAT is a contractual agreement between private parties. Usually the transferor (the annuitant or the parent) transfers ownership of an asset (real estate, stock, a business or a collectible, etc.) to the transferee (the obligor or the child or other beneficiary) in exchange for the unsecured promise to provide a stream of payments for life (an annuity contract). The PAT is simply a specific trust set up and designed to give structure, formality and a legal conduit to the private annuity contract.
- In an investment property sale you can take full advantage of this PAT structure. For example, if your property has a cost basis of \$500,000 and you plan to sell it for \$4,500,000, there would be a taxable gain of approximately \$4,000,000. Instead of paying federal capital gains taxes, potential state income taxes, and other taxes of over \$1,000,000 (\$4,000,000 gain x 25%) you can set up a PAT and pay no taxes at the time of sale. You, as the annuitant, would then be entitled to receive an income payment for life from the \$4,500,000 based on your age and the federal rates in effect at the time. At your death, your heirs may receive the \$4,500,000, minus withdrawals, plus any growth, estate tax free.

### Benefits of a Private Annuity Trust

- With a PAT, capital gains taxes, depreciation recapture taxes and state taxes are deferred until income is received with each annuity payment. This income stream may be deferred until age 70 ½. When the income is received, a portion will be subject to capital gains tax, a portion will be a tax free return of the initial tax basis in the asset and a portion will be ordinary income based on the deferred gain realized on the sale of the asset.
  - FOR EXAMPLE: If you are 58 years old and owe \$1,000,000 in combined taxes at the time of sale, you may now be able to defer those taxes until you are age 70 ½ and then receive payments over approximately another 15 years! No interest or penalties accrue on the \$1,000,000 and it is free to potentially double or even triple in value before the IRS asks for any of it.
- There are many other advantages to PATs, but another key factor is the income feature. The PAT is funded with the proceeds from the sale of your property. The trust issues a private annuity contract that is required to pay out an income for life based on interest rates and actuarial tables published by the government. As the annuitant, you will receive the federally determined amount for the rest of your life. This income can start immediately or it may be deferred. It must begin, however, by age 70 ½.

- Each payment can consist of three components: 1) a capital gains portion, 2) a regular income portion and 3) a tax-free return of principal portion. Because you will be taxed on this income, many people try to defer the income for as long as possible. At the death of the annuitants, the trust must revisit its basis and may be required to pay the remaining capital gains tax if the annuitants died earlier than their life expectancy. This has a similar effect of paying back the remaining capital gains tax that the seller would have paid at the time of sale years, sometimes even decades, before.

### Competing Alternatives

- While a PAT has become increasingly popular because of its many advantages, there are other competing strategies. If a person was selling his 2nd home - a beach house, for instance - he could consider options such as an Installment Sale or a CRT. There are pros and cons with each alternative, however.
  - In an Installment Sale there are different risks. What if the buyer defaults on his contract? You might have to take back a neglected property and sell it in a depressed market, possibly turning a profit into a loss. The depreciation recapture tax is also due up front in an installment sale. That's money out of your pocket right away. And if you were to pass away before the installments were completed then the value of the remaining portion is included back into your estate for the dreaded estate tax.
  - A CRT is another planning strategy used to defer capital gains and income taxes on the sale of an appreciated asset. However, unless you have a significant charitable intent, the PAT often provides more benefit to the family because in a CRT the assets eventually will be left to charity as opposed to your heirs.
  - In a PAT, the biggest drawback is that the trust is irrevocable and generally only the income payments can be taken out.

In spite of the increasing popularity of PATs, however, most tax professionals have little or no knowledge of their structure. Others have looked at it and found it to be too technical to be part of their everyday practice. For this reason, it is extremely important to use professionals who are familiar with and well versed in the language of Private Annuity Trusts. When set up, funded and executed properly, a Private Annuity Trust can be a versatile and valuable tool for your estate and tax planning needs.

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