

How a Private Annuity Can Save You Gift Taxes

As an estate planning technique, a private annuity is intended to transfer wealth from one generation to another while minimizing transfer taxes. To some extent, it is like betting that the mortality tables are accurate or optimistic.

In a typical private annuity, you sell property with great growth potential to your child, grandchild or a trust for the child's benefit in return for an unsecured promise to make specific fixed annuity payments to you periodically over your lifetime, at least annually.

The amount of each payment (the annuity) is determined by dividing the fair market value of the property by a factor prescribed by the U.S. Treasury based on life expectancy. The annuity's value must equal the fair market value of the property being transferred. Otherwise, the arrangement will trigger gift tax consequences.

On your death, the payments stop. For estate tax purposes, only the payments you received

during your lifetime and did not spend are included in your gross estate. Accordingly, if you die before reaching your life expectancy, less is included in your gross estate and more assets will have passed to the child tax free. If you outlive the mortality tables, however, more payments are included.

The Benefits

- You transfer property out of your estate with no gift tax consequence.
- You remove all future appreciation on the property from your estate, saving future estate taxes.
- You prevent any receivable from being included in your estate, unlike an installment sale, because when you die, payments stop.
- You include in your taxable estate only the payments you actually received to date of death, to the extent that such payments have not been spent or gifted.

- You receive cash flow to help support you during life.
- You defer some recognition of capital gain.
- You protect the property from a will contest, spousal election to take against a will and claims of your creditors because the transfer is by contract.

The Drawbacks

- The transaction is a sale, so each payment you receive is part capital gain, part interest income and part return of basis. However, the child cannot claim an interest expense deduction.
- If you live beyond mortality tables, the estate tax savings may be negated because you will receive too many payments. In addition, the child will have to make payments from his or her assets.
- If the interest earned by the child on the asset is less than the interest obligation to you, the child may have to make payments from his or her assets even if you do not live beyond mortality tables.

- Because the promise to pay must be unsecured to qualify as a private annuity, the payments to you could be in jeopardy if the child has creditor problems.
- The child's basis in the property is tied to the payments actually made.
- Formalities must be followed to sustain the transaction.

Should You Consider A Private Annuity? Yes, If ...

- **You have substantial wealth.** A significant asset is being removed from the estate, so make sure you can maintain your lifestyle without it.
- **You are middle-aged.** The mortality tables for an elderly transferor generally require payments that are too large to meet estate planning goals.
- **Your health or family history suggests the age in mortality tables may not be reached.** If you are in an advanced stage of an incurable illness, however, a private annuity can't be used.
- **The cash flow the transferred property will generate is large and the**

child will be able to make annuity payments without any out-of-pocket cost. Be careful, however, when determining the value of the transferred asset.

- **The potential for appreciation is great and the child has other funds to make annuity payments.** The child may have to fund the annuity payments out-of-pocket, but the tax benefit can be significant.

Is a Private Annuity Right for You?

For the right transferor and the right property, the tax savings from using a private annuity can be substantial.