INTRODUCTION TO PRIVATE ANNUITIES

Presented by:
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What is a private annuity?

- All of you should be familiar with annuities issued by insurance companies and how they operate.
- The client transfers funds to an insurance company in return for the insurance company’s promise to pay a certain sum annually either for term certain or the life of the annuity.
- The client is transferring management of the assets to the insurance company in return for the promises made by the insurance company.

Private annuity

- A Private annuity is the same in form and content, as a commercial annuity, except that usually a family member (a son or daughter) issues the annuity for the life of an individual or individuals (parent or parents).

What are the benefits of using a private annuity?

- First, the value of the asset is removed from the estate of the annuitant (the person receiving the payment.)
- Second, the annuitant is guaranteed a return on investment, usually for life of the annuitant, on the funds transferred to the promisor (the person issuing the annuity).
- Third, the promisor receives a step up in basis equal to the value of the property at the time of the transfer and thus can sell the property received from the annuitant with little or no tax consequences.

What are the benefits of the Private Annuity transaction to the financial advisor?

- The financial advisor would have been the one who has recognized the availability of the private annuity transaction.
- The annuitant will most likely insist that the funds remain with you, the recommending advisor, and you will get to demonstrate your investment knowledge and prowess to the next generation of offspring giving you an edge up on fund management after the death of the annuitant.

What are the detriments to the annuitant?

- The annuitant’s money could be squandered by the promisor or the promisor could have the funds attached by creditors or a spouse in divorce.
- The promisor could not fulfill his obligations to pay the annuity even if there are funds available.

What are the detriments to the Promisor?

- The Annuitant could outlive the money and the Annuitant would have to use personal funds
- The Annuitant has to pay taxes on the earnings of the fund and make distributions to the Annuitant who also has to pay taxes on the ordinary income portion of the annuity payment

An Example

- H & W are ages 65 and 60 respectively and wish to sell their family business (B) to an unrelated third party for $5 million in a stock transaction. The tax basis of H & W in B is zero. H & W have one child Z.
- H & W have other assets worth $3 million and have in place credit shelter trusts for each other. Three years after the sale H & W die.
- Assuming no other tax planning takes place and the sale is made to an unrelated third party, there will be a capital gains tax of approximately $1,000,000 ($5,000,000 times 20%) on the sale.
- Assuming no other estate planning and H & W die with a gross estate of $7,000,000 ($3,000,000 in other assets plus the $4,000,000 left from sale after taxes), their estate tax will be $2,000,000 ($7,000,000, less $3,000,000 assumed credit shelter planning times 50% estate tax rate) leaving a net estate of $5,000,000 to Z. H & W have paid $1,000,000 in income tax and $2,000,000 in estate tax.

Assume a private annuity is used.

- Immediately prior to the sale H & W enter into a private annuity agreement with Z to provide a joint and survivor life annuity to H & W of $369,350 per year in exchange for all of the stock of B.
- There is no capital gains on the transfer of B stock to Z. In each of the annual payments of $369,350 to H & W, $184,502 is capital gain and $184,848 is ordinary income. ($184,502 plus $184,848 equals $369,350.)

Example continued.

- The total income tax will be $304,791 on the three payments of $369,350 ($369,350 times 3 equals $1,108,050. Capital Gains tax will be $184,502 times 3 equals $553,506 times 20% tax rate equals $110,701, plus ordinary income annual portion of $184,848 times 3 years equals $554,544 times 35% tax rate equals $194,090. ($110,701 plus & $194,090 equals $369,350)

- Estate tax will be zero assuming balance after tax was spent.

- Thus total tax on transaction assuming private annuity transaction was used will be $369,350.

Example continued.

- Total income and estate tax without private annuity was $3,000,000.
- Total income and estate tax with private annuity is $369,350.
- Client savings of $2,630,650 ($3,000,000 less $369,350).

THANKS FOR ATTENDING

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