

Private Annuity Trusts

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With the recent boom in the real estate market, many people own property with large amounts of equity. A desire to benefit from that appreciation without paying the capital gains taxes up front has brought more attention to the Private Annuity Trust (PAT). With a PAT it may be possible to defer capital gains, create an income stream and reduce your taxable estate.

What is a PAT?

In a PAT you sell your property to a trustee in exchange for the right to receive fixed annuity payments based on your life expectancy.

How does it work?

An attorney drafts the PAT agreement in which you name the trustees and beneficiaries. You can not act as the trustee. You then transfer your property to the trustee who agrees to make annuity payments to you in exchange for the property. The trustee can then sell the property and invest the proceeds in order to generate a source for your annuity payments. The annuity payments end upon your death and the balance of the trust assets pass to your beneficiaries free of estate tax.

How are the annuity payments taxed?

When you transfer the property to the trustee and he or she sells it, you have no recognizable capital gain at that point. You are not taxed on the transfer since you have not received any cash for the sale. You are only taxed on payments as you receive them. Your capital gain is spread over your life expectancy. Each payment has three elements. The first element is a return of your principal (recovery of basis) which is not taxed. The second element is taxed as capital gain. And finally, the third element is taxed as interest (ordinary income). Provided the trustee sells the property to a third party for the same amount of the annuity contract, there are no taxes to the PAT either.

Here's an example:

You have a 15-year life expectancy. You purchased a vacant lot in 1995 for \$50,000 that is now worth \$500,000. You create a PAT which provides for an annual annuity payment to you of \$46,825. Of that payment \$6,555 is not subject to tax as return of principal, \$30,000 is taxed as capital gain, and \$10,270 is taxed as ordinary income. With regard to the trustee, he or she paid you with a \$500,000 annuity contract and sold the property to a third party for \$500,000 and accordingly there are no taxes to the PAT.

What types of properties can be transferred to a PAT?

Your second home, rental property, 1031 exchange property, commercial property and even stocks can be transferred to a PAT. Low basis assets are the most suitable for a PAT as well as assets that are likely to appreciate substantially in value.

What are the main advantages of a PAT?

A PAT creates an income stream for you in the form of annuity payments. You can defer receiving payments until you reach 70 ½. The capital gain from the sale of your property is spread over your life expectancy. The value of the property transferred is not included in your taxable estate upon your death. The amount remaining in trust passes free of estate or gift taxes to the beneficiaries.

What are some disadvantages of a PAT?

Creating an income stream can also be a disadvantage as you are now increasing your taxable income. You cannot receive more than the fixed annuity payment even if the trust assets earn more. Your trustee is liable to make the annuity payments even if the trust property is exhausted. The PAT is an unsecured agreement which means there are no guarantees that you will receive any payments if the trustee makes poor investments. Once you create a PAT it is an irrevocable agreement that can not be changed.

When does a PAT make sense?

Deciding whether a PAT is right for you is a highly individualized analysis. A PAT is a technical and relatively sophisticated technique. Generally if you have a taxable estate, need to create an income stream, and/or need to diversify assets you may want to consider a PAT.

PATs can have gift, estate, income, capital gains and intangible tax implications that should be analyzed with the assistance of a qualified attorney and accountant before proceeding.

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