

# Popular Trusts Shield Real-Estate Profits

*Private Annuity Trusts Reduce Bite of Estate Tax And Defer Capital Gains, but IRS Scrutiny Grows*

By RACHEL EMMA SILVERMAN

**T**HE SOARING real-estate prices of the past few years are helping to feed the popularity of a complex tax-savings technique called a "private annuity trust."

The strategy is being promoted as a way for investors to defer hefty capital-gains taxes on the sale of highly-appreciated assets—especially real estate—and save on estate taxes, while also generating a stream of income.

The trusts are being widely marketed not just by tax lawyers and accountants, but also by investment advisers and insurance agents—who may also stand to gain big fees by managing trust investments—and real-estate brokers, who hope that the strategy might help clinch property sales and attract listings.

They are being pitched to everyone from owners of a primary or secondary residence that has risen dramatically in value to owners of numerous investment properties. The trusts are just one of a number of strategies that people are using in an attempt to trim taxes amid the fevered real-estate market of recent years. (See chart on page D3 for more details on these other options.)

The growing popularity of private annuity trusts, however, has sparked heated debate among tax advisers, with skeptics saying that some arrangements might be too aggressive un-

## Smart Selling

Owners of real estate that has sharply appreciated have a number of options to reduce their tax hit when they sell:

- So-called private annuity trusts, structured sales and 1031 exchanges can defer **capital-gains taxes** for a long period.
- Private annuity trusts can be used to move assets **out of one's estate**, lessening the tax burden on one's heirs.
- Many people are opting to **sell property outright** and pay federal capital-gains taxes now, while rates are still low.

der allowable tax rules and might not generate all the tax benefits some promoters claim. Some tax lawyers have published articles or created Web sites criticizing the trusts, with titles such as "Private Annuity Trusts: The Numbers Don't Support the Hype."

Moreover, the Internal Revenue Service has been scrutinizing a growing number of private annuity trust transactions, and though it has not banned the practice, the agency says it has seen numerous cases that it feels do not pass muster.

Proponents of private annuity trusts, for their part, say the transaction, when done correctly, is a perfectly acceptable tax-savings technique that can defer capital-gains taxes for years and minimize estate taxes. "If you

evaluate it and set it up right and then operate it appropriately, a private annuity trust can be a great tool to use for estate transfer, asset preservation and tax deferral," says Curt Wyatt, a Palm Desert, Calif., trust adviser, who manages nearly \$800 million in private annuity trust assets, business generated in just three years.

Wendy Phillips, a Landers, Calif., real-estate investor, set up a private annuity trust after attending a seminar on capital-gains strategies at an apartment-owners' trade show. Ms. Phillips faced capital-gains taxes of some \$900,000 on the sale of several rental properties near Palm

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Springs, and wanted to avoid paying those taxes upfront. "It seemed like a lot out of our pockets at one time," says Ms. Phillips, who will turn 62 years old this month. She and her husband chose to defer the private annuity payments until they reach age 70, which means they can delay the tax hit for several years.

The National Association of Financial and Estate Planning, or NAFEP, a big provider of private annuity trusts, says that business has doubled every year since 2003 and is continuing to grow this year. The strategy is "becoming more mainstream and more people and attorneys are becoming more comfortable with it," says Roy Barker, director of operations at NAFEP, which is based in Salt Lake City.

Private annuity trusts can cost anywhere from about \$3,000 to well over \$10,000 to set up, plus additional administration and investment fees that can run upwards of 1% of trust assets. Because of these costs, Mr. Barker says the strategy makes the most sense for people who have at least \$200,000 of capital gains to defer, as well as people who might be subject to the estate tax. (The current federal estate-tax exemption is \$2 million per person or \$4 million per married couple.)

Private annuity trusts are complicated, involving lots of convoluted steps and tax rules. In a typical arrangement, you sell appreciated assets—residential or commercial real estate, artwork, securities, even closely held businesses—to a trust, in exchange for a series of fixed annuity payments that last for the rest of your life. The trust then goes ahead and sells the appreciated asset to an end buyer. The cash proceeds are invested by the trust, and are used to fund your annuity payments.

By selling the property in exchange for an annuity, you avoid paying the upfront capital gains that you would have owed if you had simply sold the asset outright.

Instead, you are taxed on the annuity payments when they come out of the trust, which spreads out the taxes over a longer period of time. What's more, you can defer receiving the annuity payments for years—most advisers recommend starting them no later than age 70—thereby further postponing your tax payments.

The strategy also has estate-planning benefits. When you die, the annuity payments stop and whatever is left over in the trust is considered out of your estate and isn't subject to estate taxes. The annuity payments you receive during your lifetime, however, are considered part of your estate unless you spend down the money.

Be aware, however, that the strategy is on the IRS's radar screen. The agency doesn't like arrangements in which sellers continue to control trust assets or properties that were purportedly sold. The IRS is also concerned that, before the trust is even set up, a buyer has already contractually agreed to take the property. In that case, the government could ultimately view the trust as an improper tax shelter, designed chiefly to avoid immediate capital-gains taxes rather than providing real economic substance.

The annuity is termed a "private annuity" because it is a special payment contract between you and the trust, as opposed to a commercial annuity issued by an insurance company. The amount of the annuity payments stays fixed over your lifetime and is determined by a formula that's set by the IRS, based on factors that include your age, the property's sale price and an IRS-determined interest rate. The older you are—or the longer you defer the annuity—the bigger the payments will be.

Jeff Reed, a Lake Forest, Calif., investment adviser, says he regularly gives seminars to hundreds of real-estate investors and brokers about private annuity

trusts and other tax-efficient ways to sell property. Private annuity trusts, in his experience, "are one of the fastest-growing exit strategies." The National Private Annuity Trust, another private annuity company, says the number of trusts it manages has more than doubled from last year, while the National Association for Private Annuity Trusts, or NAPAT, based in Irvine, Calif., says that it has grown more than 100% a year in the past three years. "It has just exploded," says NAPAT president Kevin McBarron.

One reason for the boom: sellers wishing to cash out of real estate in hot markets, such as Southern California, while locking in big profits. Even though federal long-term capital-gains taxes are at a low 15% rate for most assets, many sellers are reluctant to pay a tax upfront when they can instead defer it for years. In addition to private annuity trusts, firms are marketing a host of other strategies to defer taxes on real-estate sales, including 1031 exchanges and a new installment-payment technique called a structured sale.

Critics—and even some promoters—say that the private annuity trust strategy has downsides and isn't for everyone. "Contrary to the claims of promoters, it is a very risky transaction and in any event it will likely cause you to pay

more tax than had you not done the transaction in the first place," says Atlanta tax lawyer Kevin McGrath, who recently wrote an article critical of the tactic in the tax journal "Tax Notes."

For one, a private annuity trust doesn't eliminate capital-gains taxes; it just defers them. On each annuity payment, you'll owe taxes on both capital gains as well as ordinary income, which is taxed at a higher rate. And if you outlive your life expectancy, all of the annuity payments beyond that point will be taxed at ordinary income rates, according to tax rules. Also, the trust itself has to pay taxes on its earnings over the years, depending on how the assets inside it are invested.

Another caveat: Because these trusts are irrevocable, once you sell your property, you don't have any direct control over how the proceeds are invested. Instead, a separate trustee manages the assets. You also can't invade the trust to get more money beyond the annuity payments.

If you get pitched a private annuity trust, it's smart to have an independent lawyer and tax adviser carefully study the transaction to make sure that it passes legal muster, and to model projections on whether the arrangement works for you, depending on your age and income needs.