

Weighing Alternatives To The Private Annuity Trust

BY ROCCY DEFRANCESCO

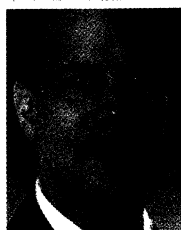
LIFE CAN BE SO IRONIC AND CRUEL. Imagine if you built your entire business on one narrow part of the tax law, and then the tax law changed because you became too successful marketing it. That's exactly what happened to private annuity trusts.

Do you have clients who want to sell highly appreciated assets and "avoid" the current capital gains taxes and depreciation recapture? Would they like to have money they otherwise would have paid to the IRS or state in taxes in an account that grows and can provide a lifetime income stream? Do they also want a plan that removes highly appreciated assets from their estates for estate tax purposes?

For many clients with highly appreciated assets, the answer is yes. Until recently, one vehicle clients could have used to accomplish the above goals was the private annuity trust. Functioning like an immediate annuity, the vehicle can provide a guaranteed income stream for life through the sale of property transferred by the client to the PAT.

But the IRS issued on October 17, 2006, proposed regulations—IR-2006-161—that would for all intents and purposes "kill" the use of PATs to defer capital gains taxes on the sale of an appreciated asset by applying the same rule to exchanges for both private annuities and commercial annuities. And if you can't use PATs for this purpose, there is little reason to use them.

What other solutions are available? There are 2 you should consider: (1) the charitable remainder trust and (2) the Intentionally Defective Grantor trust.



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CHARITABLE REMAINDER TRUSTS

By gifting a highly appreciated asset to a CRT, a client can enjoy a current income tax deduction and a reduction in capital gains taxes over time (neither of which was a benefit of a PAT). Like a PAT, a CRT provides a lifetime income stream and removes the asset from the client's estate.

By using some of the CRT's lifetime income stream to fund a life insurance policy owned by an irrevocable life insurance trust (also called a "wealth replacement trust"), the client can also leave a lasting legacy for children. The same objective can also be achieved with a charitable gift annuity.

THE CRT IN ACTION

Assume that Dr. Smith, age 60, has an estate valued at \$5 million and that he owns a rental property worth \$500,000 and has a basis of \$100,000. Assume also that Dr. Smith still works as a surgeon, making \$400,000 a year.

- 1 Dr. Smith gifts the property to a charity in exchange for a CRT.
- 2 Dr. Smith receives an immediate income tax deduction (\$60,925).
- 3 The capital gains tax is not immediate and is lessened (the tax will be paid pro rata as each payment is made from the CRT).
- 4 Dr. Smith receives \$28,000 a year as income for life (taxed similarly to PAT payments).
- 5 Dr. Smith gifts to an ILIT \$4,500 a year, and the ILIT buys a \$500,000 life insurance policy to "replace" the asset he gave away to the CRT.

The benefits of the CRT in this example are better than those a client could receive

using a PAT. That's because a PAT does not provide an income tax deduction and there is *no* discount on the capital gains tax due.

INTENTIONALLY DEFECTIVE GRANTOR TRUSTS

Most advisors will not think to use an IDGT when looking for solutions to capital gains taxes on appreciated asset. Still, the vehicle is an excellent tool for many clients.

With an IDGT, the client pays the entire capital gains tax *now*, which seems counterintuitive to those looking to defer or avoid tax. The main benefit an IDGT has over a PAT and a CRT is that the income stream from the IDGT, if set up correctly, can be *completely income-tax-free*.

The income stream derived from a PAT or CRT has a capital gains tax component based on the rate when the payment is received (which could be much higher than 15% for current long-term rates) and an income component. The longer a client lives, the more the income component to the payment.

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After a client lives to the age of assumed death, the entire income stream from a PAT or CRT is 100% income taxable. With an IDGT, the client transfers the asset to the trust where the asset is sold. The client pays capital gains taxes upon sale at the current capital gains tax rates. Then the IDGT properly invests the proceeds after tax, and the lifetime payments to the client (grantor) can be income tax free for life. The longer a person plans on living, the more tax-favorable an IDGT is over a CRT or a PAT.

To be a quality advisor in the advanced markets, you have to have multiple arrows in your quiver to provide the best advice to your clients. By learning CRTs and IDGTs, you'll have 2 additional tools with which to help clients who are dealing with the problems of highly appreciated assets. ■