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# SHOULD YOU GO PRIVATE WITH AN ANNUITY?

Are you in poor health, do you face a potentially large estate tax bill, want to transfer appreciated assets to your children, or need retirement income? You may want to consider a private annuity.

Private annuities work on the same principle as a traditional immediate annuity that you would buy from an insurance company. You transfer property—such as a family-controlled business—to a child or unrelated private third party in exchange for their promise to make periodic payments to you for the rest of your life. The size of those payments is based primarily on your life expectancy, the value of the property at the time of the transfer, and interest rates.

While the overall principle is the same with a private annuity as it is with a traditional commercial annuity, there are important distinctions that influence whether a private annuity makes financial sense.

First, you can invest only cash in a commercial annuity, but with a private annuity you typically transfer property other than cash, such as appreciated stock, real estate, or a family business (which can then be sold immediately if desired without incurring any immediate capital gains taxes). Thus, a private annuity provides the advantage of removing appreciated assets, and any future appreciation by those assets, from your estate—a huge benefit if your estate is large enough to face potential estate taxes.

Second, with a commercial annuity the best return on your investment is to outlive your life expectancy, while with a private annuity the best return is usually the reverse. A commercial annuity bases its payments on the life expectancy of your age bracket, regardless of your individual health. If you die prematurely, you or your heirs may not earn back your investment. If you live well beyond your life expectancy, you make more money on your investment, while the commercial insurer loses money.

But if you die prematurely with a private annuity, the family member or family business stops making payments and effectively buys the property at less than its actual value (though they may owe some "recapture" capital gains tax). On the other hand, living beyond your life expectancy would be more financially beneficial if you have established the private annuity with an unrelated third party to whom you otherwise would not have gifted the property.

As with most commercial annuities, only a portion of the payouts from a private annuity is subject to income tax because a portion is always treated as a return of capital. If the value of the property you transfer is larger than your basis in the property, which usually is the case, then you must recognize a gain. But any taxes due on that gain are spread out over your life expectancy.

Keep a couple of points in mind here. The value of the private annuity contract is based on Internal Revenue Service life expectancy tables (these can be structured on a joint-and-survivor basis) and on published IRS interest rates. Only if you are expected to die within a year must you use special IRS actuarial tables that reflect your shortened life expectancy (this has been an area of IRS scrutiny). Assuming the family strategy is to minimize the size the payments from the children, private annuities are particularly attractive in this current low-interest-rate environment because required payments are smaller than normal.

Also, a portion of the transfer could be subject to a gift tax if the value of the private annuity is less than the value of the transferred property. The IRS has been scrutinizing these transactions, especially the valuation of the transferred property, so have the property appraised by a qualified appraiser.

Beyond potential disputes with the IRS, the major risk inherent in private annuities is that to take advantage of the tax breaks the transferred property must be unsecured. You'll want to be confidant your children or whomever you transfer the property to (or their estate should they die before you do) are both able and willing to make the required annuity payments. You don't want to end up suing your children or your former business.

While a private annuity may be suitable for some situations, be sure to consult closely with your financial planner and tax advisor regarding other options, including outright gifting, a self-canceling installment note, passing property on at death, or using irrevocable trusts.



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