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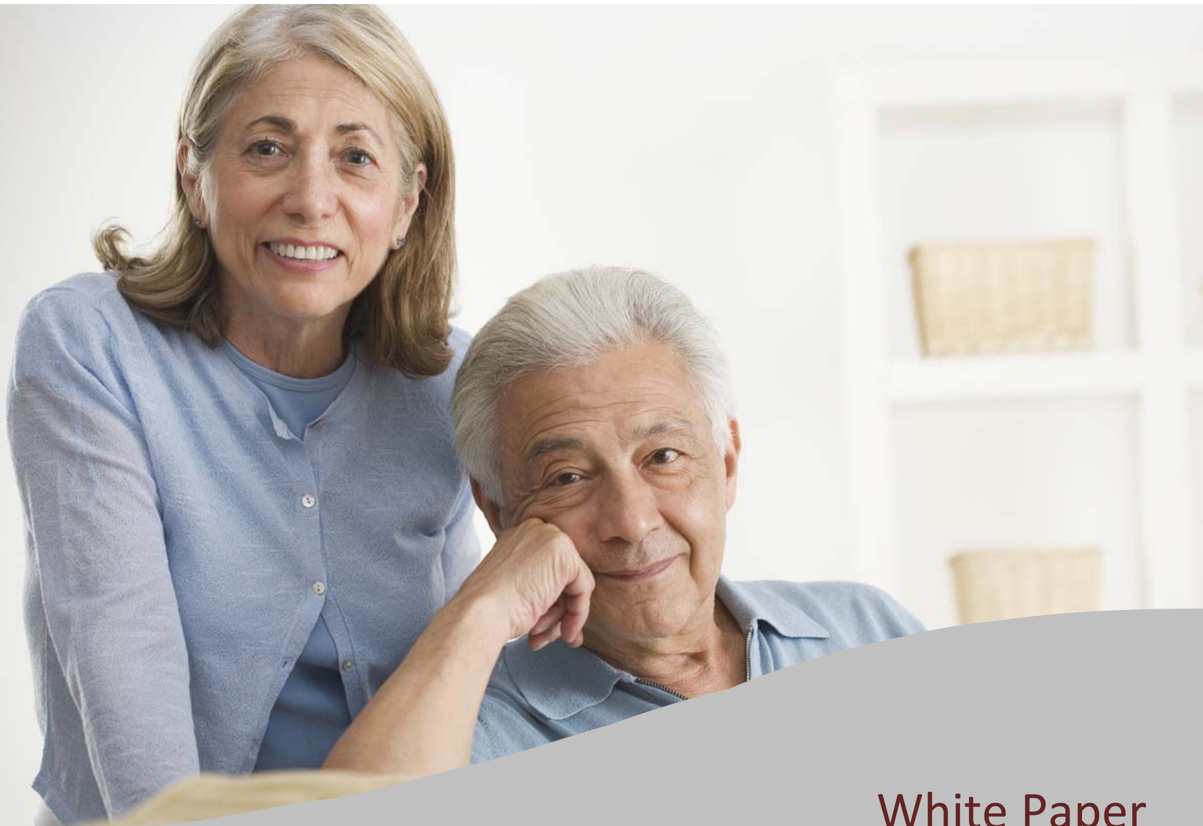

White Paper

Estate Freeze Technique:

Private Annuity

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Table of Contents

Estate Freeze Technique: *Private Annuity* 3

What is it? 3

When can it be used? 3

Strengths 4

Tradeoffs 6

How to do it 7

Tax considerations 9

Questions & Answers 10

Disclosures 12

Estate Freeze Technique: *Private Annuity*

What is it?

A private annuity is the sale of property in exchange for an unsecured promise to make payments for the rest of your life. A private annuity differs from a commercial annuity because you arrange the annuity with a private party instead of a financial organization (e.g., an insurance company). You (the seller or annuitant) transfer complete ownership of property to another party (the buyer or obligor). The buyer in turn makes an unsecured promise to make periodic payments to you for the rest of your life (a single life annuity) or for your life and the life of a second person (a joint and survivor annuity). A joint and survivor annuity provides payments until the death of the last survivor (i.e., payments continue as long as either the husband or wife is still alive). A typical private annuity involves the transfer of appreciated property from parents to their children.

Because a private annuity is a sale and not a gift, it allows you to remove assets from your estate without incurring transfer taxes. In addition, because you receive payments over the span of your life, you spread the gain recognized on the sale, deferring capital gains tax until years in which you may be in a lower tax bracket.

A private annuity can be a great way to preserve a family farm, business, or other asset, and free you from the burdens and risk of management. The big catch to this arrangement is that the buyer's promise to pay must be unsecured if you want to enjoy the tax savings. You may lose your income stream in the event the buyer fails to pay.

When can it be used?

You want to give away property during your life

You may want to dispose of certain property now instead of waiting until your death for a variety of reasons. For example, you may want to retire but need an income stream, or you may want your children to gain experience in the family business while you are still around to advise them. Whatever the reasons are, you should realize that to enjoy the tax benefits, you may not retain any interest in the property. Therefore, before you execute a private annuity agreement, be sure you are ready to give up total and absolute control over the property.

You can risk losing the income stream in the event the buyer fails to pay

It is extremely important that the promise by the buyer to make payments to the seller is unsecured. If the promise to pay is secured by a mortgage or other type of security agreement, the gain on the sale of the asset will be immediately and fully taxable to the seller. The seller will lose the tax benefit of spreading the gain over the full life of the annuity.

Because the private annuity must be unsecured, the seller should make certain that the buyer has the means to make the payments over the seller's life.

> **Caution:** Proposed regulations, generally effective for exchanges made after October 18, 2006, require that any capital gain or loss be recognized at the time of the exchange rather than spread out over the term of the annuity, regardless of whether the private annuity is unsecured.

You can risk losing the property if you die before receiving full value for the property

The private annuity is structured so that annuity payments end upon the death of the seller or, in the case of a joint and survivor annuity, upon the death of both the seller and a designated second person. What happens if the death(s) occurs soon after the agreement is executed? The buyer is no longer obligated to make payments. The buyer obtains the property for a bargain, and your heirs lose out.

Strengths

Minimizes federal estate tax and state death taxes

A private annuity allows you to remove a sizable asset from your estate without incurring federal estate tax or state death taxes. This is because a private annuity is a sale of property for which you receive a fair price and because the annuity payments cease at your death (in the case of a single life annuity). Property you sell during your life for "full and adequate consideration" is not included in your gross taxable estate for federal estate tax or state death tax purposes when you die. Likewise, income that ceases at your death is not taxable to your estate.

If you have a joint and survivor annuity and income continues to a second party after your death, the present value of those future payments will be includable in your gross taxable estate for federal estate tax and state death tax purposes. However, if the second party is your spouse, these payments are also fully deductible under the unlimited marital deduction, so no federal estate tax will actually be owed. Also, because most states have the equivalent of the federal unlimited marital deduction, no state death taxes should be due.

Minimizes gift taxes

Generally, because a private annuity is a sale and not a gift, the transfer is not subject to gift taxes. However, if the sale is made for less than fair market value (FMV), the difference constitutes a taxable gift and gift taxes (federal, state, or both) may be owed.

Minimizes generation-skipping transfer taxes (GSTT)

Generally, gifts you make to your grandchildren (or family members who are two or more generations below you) are subject to generation-skipping transfer taxes (GSTT) (federal, state, or both). As with gifts, private annuities avoid GSTT because the transaction is classified as a sale.

May defer capital gains taxes

If you own property with a low tax basis, or highly appreciated property, you will recognize a taxable gain when you sell it. Generally, a taxable gain must be reported immediately. However, because you receive the sale proceeds over an extended period of time, you spread the gain perhaps into years when you are in a lower income tax bracket.

> **Caution:** On October 18, 2006, the Treasury and the IRS issued proposed regulations, which significantly change the tax treatment of private annuity payments. Generally, under the proposed regulations, capital gains and losses resulting from an exchange of property for a private annuity contract made after October 18, 2006 (April 18, 2007 for a limited class of exchanges) must be recognized at the time of the exchange, and cannot be deferred over the life of the annuity. These proposed regulations do not apply to payments received from an annuity that was received as part of an exchange made prior to October 18, 2006.

Turns non-income-producing property into income-producing property

You may own non-income-producing property, such as real estate. You can turn this property into a stream of payments by selling it in exchange for a private annuity.

Provides a fixed lifetime income

If you own assets and would like to retire, but you depend on your salary to meet day-to-day living expenses, a private annuity may be a good arrangement for you. You continue to receive periodic payments and may even yield a higher income than if you sold the assets in an outright sale.

Helps a buyer who could not otherwise afford the purchase price

You may want to sell assets to someone who does not have the funds to make a lump-sum payment. A private annuity allows the buyer to make payments over a period of time. This works especially well if the assets are income producing.

Keeps an asset in the family

You may own assets that you want to remain in the hands of family members, but from which you need to derive an income (e.g., business interests). A private annuity lets you pick the buyer among your family members (even those who can't afford to pay all at once), and you are not forced to sell to an outsider.

Releases you from the burden of managing the assets

A private annuity is a good way to keep your financial independence without the burden of managing the assets (e.g., rental property). When transferring property that requires management, be sure that

the purchaser has the requisite knowledge, skills, and ability needed to be successful. Otherwise, you may be putting your future annuity payments at risk.

Avoids probate

Assets transferred using a private annuity do not pass through probate. This may save your estate and heirs' time, inconvenience, and money.

Tradeoffs

You cannot recover the property if the buyer fails to pay

To enjoy the tax savings, you must transfer the property without any right to collateralize any of the buyer's property in the event the buyer fails to make the agreed-upon periodic payments. The IRS sees a security interest as a retained financial interest in the property. This causes any gain to be recognized immediately and may cause the transfer to be treated as a taxable transfer for gift and GSTT purposes.

> **Caution:** Proposed regulations, generally effective for exchanges made after October 18, 2006, require that any capital gain or loss be recognized at the time of the exchange rather than spread out over the term of the annuity, regardless of whether the private annuity is unsecured.

The financial security of the buyer therefore poses a tremendous risk for you. If the buyer mismanages income-producing property or otherwise suffers misfortune, annuity payments to you may stop. Your only recourse may be to take the buyer to court for defaulting on the agreement. If the buyer files for bankruptcy, secured creditors will be paid before you. In the end, you may not get full value for the property you sell. If the buyer predeceases you, it will be difficult to enforce the obligation against his or her estate. You should carefully consider the financial, emotional, and domestic-relations statuses of the proposed buyer before you enter into any private annuity agreement.

You may die before receiving full value

When you arrange a private annuity, you must transfer total and complete ownership of the property to the buyer. You can retain no interest whatsoever. Also, payments end when you die. What happens if you die soon after making the agreement? The buyer stops paying and gets the property cheap. Your heirs do not receive the full value of the property.

If you live longer than expected, you must recognize taxable income

Another risk of a private annuity is that you may live beyond your expected life span. If you outlive your life expectancy, the buyer's obligation to pay is not released. Payments will continue until your death. The result is:

- The buyer overpays for the property
- You recognize income that is taxed as ordinary income

- Payments beyond your life span may increase your estate so that it exceeds the amount it would have been if the asset had not been transferred

You give up control of the property

Because you must not retain any interest in the property, you give up control of that property, totally and absolutely. Do not consider this strategy if you are not ready to hand over the reins to someone else. This may be especially important if the property is a business interest.

Can be costly to implement

Substantial legal costs and other expenses (e.g., appraiser, accountant, and tax preparer fees) may be incurred in connection with a private annuity.

How to do it

A private annuity can be arranged using any type of property (e.g., a home, real estate, stocks, or a business interest).

Determine fair market value

The first thing you must do is determine the FMV of the property you are selling. This is important. You need an accurate value to know that you are getting a fair price for your property. Additionally, the IRS may challenge the value if it is not reasonable. If the IRS is successful, (1) the transfer may be deemed a gift or partial gift subject to GSTT or gift taxes or both, and/or (2) you may have to report a larger gain on the transaction.

You should be thorough and careful when arriving at a reasonable value. Use published references (newspapers or valuation tables issued by the IRS) when possible. Refer to IRS regulations and rulings, and seek advice from qualified experts and appraisers. Be sure to create documentation to back up the values you establish.

Calculate annuity using IRS annuities for life tables

Once the FMV of the property has been established, you need to look up the applicable annuity factor on the annuities for life tables issued by the IRS. These tables are based on your life expectancy and are classified by single life or two life and by the federal discount rate. For example, say you're making the agreement for a single annuity in a month, when the federal discount rate will be 8 percent. You refer to the table labeled single life, 8 percent, and look up your current age. Say you are 65. The factor is 8.1360. You then divide the FMV of the property by this factor. Say the FMV is $100,000. The amount of the annuity is $12,291.

> **Tip:** It may be a good idea to hire an accountant or actuary to calculate your annuity.

Ascertain ability of buyer to make payments

If the buyer has sufficient independent income, any of your assets can be sold with relative confidence that the buyer can make the annuity payments when they are due. But, if the buyer has little or no income, be sure that the property you are selling produces sufficient income to cover the payments. If this is not possible, at least be sure that the property is of a type that can be easily sold or borrowed against.

> **Caution:** The buyer should not be a person who regularly engages in issuing private annuities. This may cause the IRS to classify the annuity as a commercial annuity, and the benefits of the private annuity will be lost. Typically, the buyer is someone who is the natural object of the seller's bounty.

Draft a written agreement

Once the details of the arrangement are agreed upon, put them in writing. It is recommended that you hire an attorney to draft the agreement. This is especially important because your interest must be unsecured. The terms of the agreement should be clear and easy to prove in case the buyer defaults and you wind up in court.

Property transfer must be complete and absolute

You must transfer complete and absolute ownership of the property to the buyer. It is extremely important that the buyer's promise to pay is unsecured; otherwise, a taxable event will occur immediately upon signing the agreement. This means that you cannot retain a pledge, mortgage, lien, or any security interest in the property. Make sure that: (1) the agreement clearly states that the promise is unsecured and (2) a security agreement (a UCC form) is not executed or filed.

Report GSTT and/or gift taxes, if necessary

If the annuity is arranged for less than the property's FMV, the difference is a taxable gift. If the difference is greater than the $12,000 annual gift tax exclusion, you must file a federal gift tax return (Form 709). Any gift tax owed may be offset by your $1 million gift tax applicable exclusion amount, if it is available. Depending on your state, state gift tax may also be owed.

If the gift is made to a skip person (i.e., a family member who is more than one generation below you) and the difference is greater than the annual gift tax exclusion, you must file a federal gift tax return (Form 709). You may offset the gift with your lifetime GSTT exemption ($2 million in 2008), if you elect to do so. Depending on your state, state GSTT may also be owed.

File annual income tax returns

You will have to file an annual income tax return for each year you receive the annuity payment. The annuity payments can include return of capital, gain, and ordinary income. These amounts are calculated by formula.

Tip: It may be a good idea to have a tax specialist prepare your income tax returns.

Tax considerations

Income Tax

Seller's gain is recognized ratably over life of annuity

Each annuity payment is treated as part tax-free return of basis, part capital gain, and part ordinary income until your entire basis is recovered. Once your basis is recovered, the entire annuity is treated as part capital gain and part ordinary income until you have surpassed your life expectancy. Payments received after your life expectancy is taxed as ordinary income.

Caution: The part of the annuity that is allocated as interest (ordinary income) earned by the seller is not treated as interest paid by the buyer. The buyer cannot deduct this amount as interest on his or her income tax return. The buyer must treat the entire annuity payment as basis for the property.

Tip: You may want to hire a tax specialist to prepare your tax returns.

Caution: On October 18, 2006, the Treasury and the IRS issued proposed regulations, which significantly change the tax treatment of private annuity payments. Generally, under the proposed regulations, capital gains and losses resulting from an exchange of property for a private annuity contract made after October 18, 2006 must be recognized at the time of the exchange, and cannot be deferred over the life of the annuity. These proposed regulations do not apply to payments received from an annuity that was received as part of an exchange made prior to October 18, 2006.

Tip: For certain exchanges of property, the effective date of the proposed regulations is April 18, 2007. In general, this extended effective date applies where the exchange involves an unsecured annuity contract issued by an individual and the property is not sold or disposed of for a two-year period.

Estate Tax

Generally, neither the transferred property nor the annuity payments are included in the seller's estate

Neither the value of the property transferred, nor the value of the promised payment is subject to federal estate tax or state death taxes unless the annuity is joint and survivor. If payments continue to a second person after you die, the present value of the payments to the survivor will be included in your gross taxable estate for federal estate tax and state death tax purposes. If the joint sellers are married, though, the inclusion in the estate of the first to die will be offset by the federal unlimited marital deduction for federal estate tax purposes, and any applicable state marital deduction for state death tax purposes.

Gift Tax

Generally, no gift taxes are due

Generally, the value of the property transferred is not subject to federal gift tax or state gift tax. To the extent that the transfer is for less than FMV, the difference is a taxable gift.

Generation-Skipping Transfer Tax

Generally, generation-skipping transfer taxes are not applicable

Generally, the value of the property transferred is not subject to federal or state GSTT. To the extent that the transfer is for less than FMV, the difference is a taxable transfer.

Questions & Answers

What type of assets can be transferred in a private annuity arrangement?

Any type of asset may be transferred from the seller to the buyer. Stocks, bonds, undeveloped land, houses, businesses, and virtually any other type of asset may be used. Ideally, the asset should be one that will appreciate rapidly, is income producing, and is not subject to indebtedness, depreciation, or an investment tax credit.

Can there be any type of collateral or security agreement securing the annuity payments?

One of the tradeoffs of a private annuity is that there can't be any type of collateral, security agreement, or escrow fund to secure the annuity payments. If the annuity payments are secured, then the seller has a tax liability in the year of the transaction for the entire capital gain. This result would defeat one of the main benefits of a private annuity--spreading the full capital gain over the life span of the seller.

Caution: Proposed regulations, generally effective for exchanges made after October 18, 2006, require that any capital gain or loss be recognized at the time of the exchange rather than spread out over the term of the annuity, regardless of whether the private annuity is unsecured.

Can life insurance be used to secure the annuity payments?

If the buyer dies before the seller, the buyer's estate must continue to make annuity payments until the seller's death. This may cause a hardship on the buyer's heirs. Although life insurance can't be used to directly secure the annuity payments, the buyer's heirs may purchase insurance on the buyer's life--payable to themselves or to an irrevocable life insurance trust--and use the proceeds to make the annuity payments.

Are there other uses for life insurance with a private annuity?

Yes. A life insurance policy on the life of the seller may be used to equalize an estate between two or more heirs.

Example(s): A father owns a closely held business that is the primary asset in his estate. He has a son and daughter. The son works in the business and would like to own it. The daughter is not involved in the business and has no interest in an ownership position. The father would like to retire and transfer the business to the son using a private annuity. He is concerned, though, that his daughter will inherit little when he dies. To equalize the assets, the daughter could purchase a life insurance policy on the father. When the father dies, both the son and the daughter will receive roughly equal assets from the father.

What is the buyer's basis in the property acquired?

When the private annuity transaction takes place, the buyer's basis in the property becomes the present value of the stream of annuity payments (or the FMV of the property because the annuity payments should have a present value equal to the FMV of the property). However, if the seller dies before his or her actuarial life expectancy, then the buyer's basis becomes the sum of the annuity payments actually made. Similarly, if the seller lives longer than expected, the additional payments made by the buyer are added to the basis in the property.

What if the seller lives past his or her expected life expectancy?

The buyer must continue to make annuity payments until the seller dies, even if the seller lives beyond his or her life expectancy. Therefore, before a buyer enters into a private annuity transaction, he or she might want to consider whether the seller is in good health and has a history of longevity in his or her family.

What if the seller's death is imminent at the time of sale?

Because a private annuity is computed using mortality tables, a seller who is terminally ill is treated differently. The life expectancy tables issued by the IRS may not be used if there is at least a 50 percent

chance that the seller will die within one year of the date the annuity is arranged. In this case, the regular annuity tables must be used instead of the annuities-for-life tables.

If the seller lives longer than 18 months after the annuity is arranged, then he or she is presumed not to have been terminally ill.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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