Tax Letter

November 2006, Vol 14 - Private Annuity Contract

Dear clients and friends:

Private Annuity Contract has been around for quite some time, and could be a powerful retirement and estate planning tool. It is based on several cases and revenue rulings, particularly Revenue Rulings 55-119, 69-74 and 72-71. The following method, in our opinion, is the best way to explain this special arrangement.

Let us assume that there is an elderly man who is the owner of an independent business. It took him a lifetime to build. In the past, he relied heavily on the income from the business to support his family, sending his children to College, etc. Now, all his children are grown and he is ready to retire. Again, he will need the income from the business to supplement his retirement from Social Security and others.

Definitely, he can sell the business to an outsider. However, he has difficulty to part with a business that took a lifetime to build. Further, if he sold the business for lump sum payment, then, he may have to pay a very high Capital Gain tax (combining Federal and California could be as high as 24.3%). If he sold the business on an installment method, he is exposed to certain risks, such as (a) the buyer may run the business down and can not afford to pay, or worse (b) the buyer may file for bankruptcy.

By taking advantage of the Private Annuity Contract arrangement he can sell the business to one of his children without incurring a large capital gain tax upon sale. The built-in capital gain will be deferred and gradually recognized along the time upon receipts of annuity payments. Further, he can choose among his children and sell the business to the one who is willing, ready and able to take over. Since the business is “sold” to one of his children, normally, there will be no bad emotional feeling. When something is passed along from father to child, it is in the natural course of thing. Second, it is considered a “sale” and not a gift, thus, it will not be included as part of his estate, resulting in no estate and gift taxes.

Upon receipt of the annuity payment from the Buyer/child, the receiving parent will be taxed in the year of receipt. The total annual receipt will be divided into 3 parts, namely the return of capital, the long term capital gain and interest income. The return of capital portion will not be taxable. The long term capital gain will be taxed at a maximum rate of 15% for Federal purposes. The interest income portion will be subject to ordinary income treatment.

The Buyer/child who is the payor of this PAC annuity cannot deduct the annuity paid. However, if could be justified, the interest portion of the annuity payment may be allowed to deduct as "investment interest" according to the rules for "investment interest" expense deduction.

At the end, upon the death of the annuitant, the Buyer/child will be relieved from all obligations even if there is unpaid, remaining value from the PAC sale. Further, this relief from obligation will not be considered as a forgiveness of debt, therefore, not a taxable event for the Buyer/child.

In order for the IRS to accept any PAC arrangement, at least, the following key requirement must be observed in good faith:

(1) The present value of the PAC "sale" must be the current fair market value;
(2) the appropriate IRS actuarial table must be used to determine the years of life expectance;
(3) the then correct Applicable Federal Rate must be used as the built-in interest rate for the annuity calculation;
(4) the annuity payment obligation can not be secured or collateralized in any form or manner; and
(5) annuity payment should be made until the death of the Seller/parent or death of both parents, whichever the case may be.

Any question, please give us a call at 415-381-0681, or visit our website at www.chochan.com.

Sincerely,

Cho F. Chan, CPA, Inc.