SELECT PORTFOLIO MANAGEMENT, INC.
Integrated Wealth Management
A Registered Investment Advisor

White Paper:

Private Annuities

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What is a Private Annuity?

Unsecured, private financing agreement

A private annuity is sometimes used to fund the lifetime sale of a business interest to a relative or to the business itself. It is an unsecured, open-ended installment sale agreement between the two parties in which the buyer promises to make payments of a set amount (the annuity) to the seller for the rest of the seller's life, based on the seller's life expectancy as determined by mortality (actuarial) tables. Unlike an annuity contract purchased from a commercial insurance company, a private annuity is a contract with a private individual or organization. A private annuity can't be secured by a note or by collateral (i.e., you can't take your property back if your buyer decides to stop paying).

How it works

For example, you are a business owner, presently in poor health, and you wish to retire from the business. You decide to sell your business interest to your child at the fair market value (FMV) price. In return, your child promises to pay you a certain amount each year (the annuity) based on your current life expectancy as determined by published mortality tables, current interest rates, and the FMV price.

Private annuity payments for the sale of your business interest continue for the rest of your life. When you die, the annuity stops. Your estate won't include the value of either the business interest or the annuity. You can also choose to spread the payments out over the joint life expectancy of yourself and your spouse. In this case, when you die, payments would continue for the remainder of your spouse's life.

When can it be used?

You want to sell your business during your lifetime and receive income for the rest of your life

If you want to sell your business interest during your lifetime and receive income until you die, a private annuity may be an appropriate funding method for your buy-sell agreement. Private annuities are especially valuable when the seller is in poor health and the buyer is a family member.

Strengths

Useful way to finance sale of business when seller in poor health and buyer is family member

A private annuity can be used to fund the lifetime sale of your business interest if you are in poor health and are not likely to live out your life expectancy. You would sell your business interest to the buyer (ideally, a family member in this case) who would make annuity payments to you until your death. Your buyer (e.g., your son, daughter, or grandchild) could pay very little for your business interest.

> **Technical Note:** In general, the rule is that you must have a 50-50 chance of living one year beyond the date of the private annuity agreement. The payment amount is calculated based on the life expectancy tables, not your actual life expectancy. Of course, there is always the chance you will outlive all expectations and receive payments from the private annuity stream that exceed the sale price (meaning that the buyer pays a lot more for your interest than expected!). See Questions & Answers for more information on outliving life expectancy.

> **Tip:** Arrange for a medical assessment to document the seller's condition as of the date of the buy-sell transfer and annuity agreement. Keep the medical documentation for use if the IRS should challenge the private annuity.

> **Caution:** There are different rules in place for terminal illness, which may defeat the purpose of the private annuity. Consult your tax advisor.

Allows value of business interest to be removed from estate

When you accept a private annuity for the sale of your business interest, the current value of the business interest is removed from your estate. When you die, the annuity payments stop and are not included in the value of your estate.

You receive payments from the sale of your business interest for the rest of your life (see Tradeoffs)

When a private annuity is used for funding the sale of your business, you are promised periodic payments of the sale price plus interest for the rest of your life. This differs from an ordinary installment plan, from which you would receive payments only for a specific period of time.

May defer capital gains tax

When you sell or transfer your business interest during your lifetime (e.g., at your retirement), use of private annuity funding can allow you to spread any capital gain from your sale over your life expectancy as derived from the mortality tables.

> **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.

Can be effective tool for keeping business interest in the family

Sometimes, the primary objective with a family-owned business is to ensure that the business remains in the family, with less emphasis on the sale price or payment method. When your buyer is a family member, private annuity payments can be an important funding method, allowing the business to stay within the family while minimizing the cash needed at the time of the transfer.

> **Caution:** It might be tempting to set a low annuity payment by using a long life expectancy period. Be aware, however, that the actual life expectancy of the seller is not normally considered. Life expectancy must generally be derived from the IRS mortality tables, although there have been rare exceptions that have held up in court.

> **Tip:** If you want a longer payment period and you are married, consider choosing the joint life expectancy of you and your spouse for the payment period basis.

Very simple funding method

A private annuity can be a simple process. When the time comes to make the purchase, the buyer makes a promise to pay you for the rest of your life and begins the payments to you.

> **Caution:** If the business itself is the buyer, private annuity payments are generally made from business profits. This means it is possible you may not get any cash at all if the business can't make payments.

Tradeoffs

Buyer gets the business, but you might not get all the cash

The buyer takes control of the business at the time of the sale. The business is now burdened by the need to make the private annuity payments, thus lowering the income of the new owner. It is possible that the burden of the private annuity payments might affect the buyer's ability to get outside credit, in turn affecting the ability to expand the business. You bear the risk that, under the new owner, the business could run into financial difficulty and won't be able to continue your payments.

When you die, payments stop, even if the entire sale price hasn't been paid out

The private annuity payments end at your death (unless you have chosen joint life expectancy). If you die before the entire purchase price is paid to you, your estate will not receive the unpaid balance of the purchase price.

> **Tip:** When your buyer is a family member, this may not even be a concern. Your main objective may have been to keep the business in the family at a minimal cost.

Agreement cannot be secured by mortgage, note, or collateral

The private annuity cannot be secured by a mortgage, collateral, or an escrow account without losing its estate tax advantages. If the buyer stops paying you, you don't have property or equipment you can take title to or a promissory note to bring to court. You would, however, be entitled to bring a claim for breach of contract and seek damages that way. If you did keep a security interest, the value of the security would have to be included in your estate at your death, defeating the major reason you might have done the private annuity.

You might outlive the person paying the annuity

If the payor of a private annuity is an individual, it is possible that the person could die before you do. The payor's estate or heirs would be liable for the continued payments. Unfortunately, your claim against the estate or heirs would be unsecured, and it is possible you might not get your money.

> **Tip:** A life insurance policy on the payor's life, payable to the payor's estate, might help to assure your continued annuity payments if the payor dies first.

Attribution rules apply to family corporation

If the business is a corporation and the shareholders are related to each other, (including spouse, parents of either spouse, their children and their spouses, and any natural objects of the transferor's bounty), the attribution rules (see Section 318 of the Internal Revenue Code) must be considered. The attribution rules can affect the tax treatment of a shareholder when the corporation is the buyer of the interest (stock redemption). In a family corporation, the sale of stock to the business itself usually results in dividend treatment to the redeeming shareholder, and the amount of the stock redemption is subject to income tax at the ordinary income tax rates, rather than the lower capital gains tax rate.

> **Tip:** The attribution rules won't apply if the buyer of your business interest is an individual instead of the corporation itself.

How to do it

Think about how much risk you are willing to accept

If you are confident that your buyer will be able to make payments to you for the rest of your life in exchange for your business interest, then using a private annuity to fund the purchase may be appropriate for the sale of your interest. On the other hand, if you would like more certainty that payment for your interest will be both available and in full, you may want to consider alternative financing methods such as secured installment payments.

Determine the private annuity payment amount

The amount of the payments will be determined at the time of the business transfer, (e.g., your retirement). The amount is calculated based on your life expectancy from mortality tables, your age on the transfer date, interest rates at the time of the transfer, and present value factors.

> **Tip:** Consult your tax advisor when establishing the private annuity payment amount. There can be expensive tax consequences if the amount is not set correctly. See the discussion of gift tax below for more on the consequences of an incorrect payment amount.

Tax considerations

Income Tax

Seller may have to recognize gain

If the value of the business has appreciated, you may have to recognize taxable income. The gain can be spread out over your life expectancy from the mortality tables.

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> **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.

Buyer's payments not deductible

Private annuity payments are not tax deductible for the buyer of the business interest.

Gift and Estate Tax

Value of business not included in estate

When you transfer your business interest and begin receiving private annuity payments, your business interest transfers to the buyer. When you die, the value of the business interest you sold during your lifetime is not included in your estate.

If payment amounts are too low, gift tax may be incurred

If the amount of the private annuity is less than the amount prescribed by the life expectancy tables, the IRS could claim that the buyer has paid for property at less than its true value. The difference between the payment amount and the value set by the IRS would then be taxed as a gift. It is possible to structure the transfer of the business as partly a gift and partly a private annuity; however, a gift could result unintentionally through the incorrect calculation of the annuity payments. If the value of the business interest sold equals the present value of the private annuity obligation, a gift would not arise. Consult your tax advisor.

Questions & Answers

What if you live longer than the mortality tables or your doctor's prediction?

Mortality tables are based on insurance company experience and mathematical formulas. It is entirely possible that you may live longer than the time frame estimated when the private annuity begins. Likewise, you may be in poor health and yet outlive your doctor's expectations. If you live too long, the buyer of your business interest ends up paying you more than the fair market value price. Under the terms of the private annuity, you receive payments from the time you transfer your business interest to the buyer until your death.

What are the tax consequences of outliving the life expectancy used as the basis of the private annuity payments?

With the private annuity, your basis in the exchanged property would be recovered over the life expectancy period. If you live longer than the life expectancy period, payments received are treated as ordinary income.

How is the private annuity financing method different than a regular installment payment agreement?

Under both the installment payment and the private annuity methods of financing, the seller receives payments for the business interest over some period of time. Both can be effective funding methods for the sale of a family business. There are some major differences between the two methods, however, as shown in the table below.

Characteristic	Installment Payments	Private Annuity
Interest deductible for buyer?	If buyer is material participant in business	No
Payment secured?	Yes	No
Payments continue after death of seller?	Yes	No
Unpaid balance included in seller's estate?	Yes	No

Disclosures

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