



Private Annuity Trust

Introduction

Private Annuity Trusts (PAT's) are legal devices used to defer capital gains in a manner that is beneficial to an owner of substantially appreciated property. The use of PAT's has recently become popular due to the sudden increase in real property values. With such substantially appreciated property combined with aging baby boomers and older people who own property, the usage of a PAT has been invaluable. The IRS, however, hasn't been in favor of PAT's for the same reason that individuals have liked PAT's.

The IRS has recently enacted rules that make the Private Annuity Trust far less effective for any income tax deferral of appreciated property. Any PAT "purchased" after October 18 of 2006 will be denied a tax deferral benefit. Most of the leverage that the PAT

possessed to dampen financial gains was due to a Revenue Ruling from the late 1960's. With the recent rules that were enacted, the PAT is no longer effective for lessening capital gains taxes.

Estate Planning

While the PAT is no longer effective for capital gain deferral, the PAT is still an effective estate planning device. Estates that are threatened by the prospect of estate taxes can reduce the potential tax burden by placing property of all types into a PAT. Once this is done, the value of the estate can be legitimately discounted in value and, thus less estate taxes will typically be paid at the time of death of the creator of the PAT.

Continued on Page 2



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A CASE STUDY

The tax Court has held that a post death sale provided the best evidence of value for a decedent's estate. In the case, the decedent died owning a minority interest in a bank. An unrelated third-party owned the remainder of the shares. A year before the decedent's death, the unrelated third party purchased shares for approximately \$1,000 per share on two occasions. After the decedent's death,

he decedent's shares were valued at slightly below \$8,000. The decedent's shares were then sold for approximately \$9,000 per share. The Tax Court ruled that the post-death sale was the best evidence of fair market value because it was an arm's length transaction within a reasonable time of death. The two previous pre-death sales were not indicative of the value because 10 the sellers were not knowledgeable of the value of the shares. Further, the

Continued on page 3



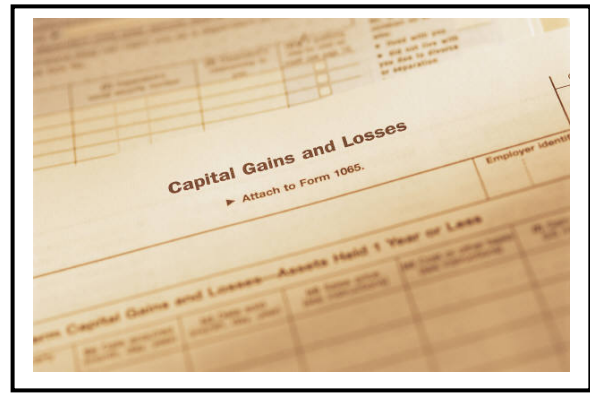
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Private Annuity Trusts are also still effective for providing the taxpayer with a retirement income even though there is no deferral of income taxes if the property is sold. Low or non-income producing property can be converted into an income producing scenario for the taxpayer, i.e., the annuity holder. Additionally, by placing the assets into an irrevocable trust outside of the estate, the asset or assets are placed outside the reach of any potential creditors and result in the property going to the beneficiaries named. Further, there is also the effect of less gift taxes due and a wealth leverage effect for the annuity holder. Even though the PAT is ineffective for capital gains deferral, plenty reason still exists for purchasing and holding a PAT.

The Alternatives

Although the PAT is ineffective for capital gains deferral on appreciated property, plenty of legitimate, legal tax planning devices still exist for the taxpayer who is holding substantially appreciated property and wanting to defer capital gains. Among the better devices to defer gains, is the section 1031 "like-kind exchange" and its permutations, including the reverse exchange and Starker exchange. There is also the installment sale, which is not always commonly used, but is a good way to defer taxes.

The 1031 like kind exchange is an excellent and popular device for deferring capital gains, sometimes for an indefinite duration. The tax practitioners at The Center are thoroughly versed with all aspects of the rules and execution of the like kind exchange. In a like kind exchange, property is exchanged for property of the same nature. The effect of this is that the substantially appreciated property is exchanged for other property the taxpayer may have a better interest in owning. The continuation of investment is preserved and no taxes are paid. The like kind exchange has also been modified to make it possible to first sell the property and then purchase new property. One word of caution, certain, particular formalities must be observed or huge capital gains can result from the transaction. Therefore, it is best to work with a qualified tax attorney in these situations.



Installment sales are also important regarding tax deferral on capital gains. In Installment Sales, property is sold. The buyer does not get bank financing, but uses the owner as the financier. The buyer makes payments to the seller and the seller reports the income as the income comes in to the seller. It must be remembered that all such transactions must involve non-negotiable notes, not negotiable notes. Installment sales have their drawbacks in the fact that often, the seller and buyer may encounter legal difficulties along the way. Careful attention must be paid to the documents dictating the transaction and are best drafted by an experienced tax attorney.

Conclusion

The Private Annuity Trust has lost its leverage and strength as a capital gain tax deferral device. Despite its loss, it remains a good estate planning instrument together with other legal devices that exist to defer capital gains for the benefit of the property holder. If you find that your property has substantially appreciated and would like questions answered, don't hesitate to contact the tax, legal and financial professionals at the Center.

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decendent's shares in the bank were the only shares not owned by the third party. Therefore, the value of the decedent's shares was determined to be in the \$8000 - \$9000 per share range.

Editor's Comment: Many times, business appraisers use methods of valuation that gives them a reasonable estimation of the value of a business. Sale of the business itself is always an excellent, near perfect way to value the company. When dealing with estates, clients are best advised to wait up to twenty-four months after the filing of the estate tax return if they use a conservative value for the valuation.

What is also significant is that the estate tax exemption is increasing in the next few years. While the valuation must be within a reasonable range and supported by fact, law, and numbers, clients are best advised in the next few years to be liberal on estate appraisals and business appraisals. Appraising the estate high gives the heir the benefit of a stepped-up basis and less capital gains when the business, stock, or item is sold. The Center routinely creates succession plans, business valuations, and estate plans for business and individuals. This bundled service is of benefit to all who use it, because The Center has the ability of seeing the big picture for the client regarding estate and income tax.



What Is Your Game Plan for Retiring from Your Business?

In their book, *The \$10 Trillion Opportunity*, Richard Jackim and Peter Christman note that: "...Within the next 20 years, more than 90 million people in the US and Canada will be retiring. These are the "baby boomers," the generation born between 1946 and 1964...Baby boomers have been the most affluent and influential population group in the history of mankind, and now they're getting ready to retire.

Economist and demographic expert Robert Avery at Cornell University predicts baby boomers will transfer 10 trillion dollars to later generations -- the largest generational transfer of wealth in the history of humankind. The vast majority of this wealth is held as stock in more than 12 million privately owned businesses, and during the next 10 - 15 years, more than 70 percent of these companies are expected to change hands."

Yet, according to the authors, in spite of overwhelming evidence that exit planning is a vital part of business ownership, most business owners don't create an exit plan.

"Due to lack of good planning, on 30 percent of family-owned businesses survive through the second generation. A study of 300 former business owners who sold their companies within the last 12 months showed that 75 percent of the respondents felt the sale did not accomplish their personal or financial goals. These statistics suggest too few business owners are proactively planning for the inevitable exit process."

If you know of a business owner who's thinking of selling or buying a business and who might benefit from a free consultation with us, have them contact me, or any of the M&A professionals at www.bradwaygroup.com

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Frequently Asked Questions...

Q1: I just opened a business and formed it as a Limited Liability Company under my state's laws. For federal tax purposes, how do I classify my LLC?

A1: An LLC may be classified for federal tax purposes as a sole proprietorship, a partnership, or a corporation. If the LLC has only one owner, the LLC will be automatically treated as a sole proprietorship unless another election is made by the owner. On the other hand, if the LLC has two or more owners, it will be classified as a partnership unless an election is made. The election is made on IRS form 8832. Unless the election is made, the classification will be the default classifications.

Q2: I am a sole proprietor. Must I have a tax identification number?

A2: The sole proprietor is the only classification of business entity that does not need a tax ID number. However, if the sole proprietor has employees or a pension plan he or she must report, it must have a taxpayer identification number. In the case of the proprietor having no employees or reportable pension obligation, the proprietor's number is his or her social security number.

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