

Friday, October 5, 2012

Estate tax magic: private annuities

Bruce Givner is a partner at Givner & Kaye APC in Los Angeles. He can be reached at bruce@givnerkaye.com.



Owen Kaye is a partner at Givner & Kaye APC in Los Angeles. He can be reached at owen@givnerkaye.com.



Families are trying to take advantage of the \$5,120,000 gift tax exclusion before it is reduced on Jan. 1, 2013, to \$1,000,000. On that same date the estate and gift tax rate will increase from 35 to 55 percent. Will the tax laws really change? There are (at least) four possible outcomes: \$5,000,000 exclusion (Congress will pass a law to keep it this way); \$3,500,000 (President Barack Obama's view); \$1,000,000 (it will become unless the law changes); and zero (estate tax repeal). What are each possibility's chances? This is a pure guess: 50 percent it will stay at \$5,000,000 (Congress will view a reduction to \$1,000,000 as an increase in the hated "death tax"); 10 percent it

will drop to \$3,500,000 (only President Obama supports this); 10 percent it will drop to \$1,000,000 as currently scheduled (again, viewed as a tax increase); and 30 percent repeal of the estate and gift tax laws. The possibility of complete repeal increases with the likelihood that Gov. Mitt Romney will become president (17.3 percent according to FiveThirtyEight.com on Sept. 29).

Most families, though interested in saving their children estate tax, cannot "give" significant assets. They need the assets - or at least the income - until the surviving parent's death. Happily, there is a way for Mom and Dad to both (i) dramatically reduce the ultimate estate tax and (ii) keep the income as long as either of them is alive.

A private annuity is a stream of payments made by a children's trust that continues as long as either Mom or Dad is alive. (The children's trust will be drafted to be "ignored" for income tax purposes.) Because payments stop at the surviving parent's death, nothing is included in the surviving parent's estate. If Mom and Dad die prematurely, a private annuity provides a terrific result: transfer of a valuable asset out of the estate in return for one or a few very small payments.

Some people believe that a "private annuity" requires buying something from a financial institution. Untrue. However, like a commercial annuity, the payments essentially consist of two elements: interest and a mortality cost. The interest is a special rate, the IRC Section 7520 rate, required by the Internal Revenue Service for transactions involving annuities. Therefore, it is used for qualified personal residence trusts (QPRTs), grantor retained annuity trusts (GRATs) and charitable remainder annuity trusts (CRATs). For October 2012, the rate is 1.2 percent. The mortality cost increases with the parents' ages. It is approximately 3.4 percent for parents ages 65 and 60; 5.3 percent for parents age 75 and 70; 9.2 percent for parents ages 85 and 80; and 15.8 percent for a single parent age 85.

Mom and Dad have a debt-free apartment building which they believe is worth \$10,000,000. It generates distributable cash flow of only \$200,000. They would like to reduce whatever estate tax might apply on the survivor's death. However, they cannot afford to give up the \$200,000 per year. A "gift" of the apartment building, from which they retain the \$200,000, would be ignored due to Internal Revenue Code Section 2036, which includes in the estate any transfer if you retain the income from the property or the right to designate who will enjoy the income from the property.

The \$5,120,000 gift tax exclusion ... is reduced on Jan. 1, 2013, to \$1,000,000. On that same

Intellectual Property

Google digital library still faces obstacles despite settlement with publishers' group
Google Inc. still has many hurdles to overcome in starting its digital library even after announcing a settlement Thursday with the Association of American Publishers.

Corporate

Say-for-pay rules mean more work for lawyers

Securities lawyers are getting more work from their established, publicly traded company clients due to rules that require public company compensation plans to be brought to the company's shareholders for a vote.

Litigation

Constitutionality of 'fire fee' challenged

A California taxpayers association filed a lawsuit Wednesday challenging the constitutionality of a new \$150 annual fire fee imposed on rural homeowners.

Corporate

Kirkland represents investment firm in aircraft leasing company sale

Kirkland & Ellis LLP advised Oaktree Capital Management LP reached an agreement with a leasing arm of Mitsubishi to sell a San Francisco-based aircraft leasing company for \$1.3 billion.

Mergers & Acquisitions

Dealmakers

A roundup of recent mergers and acquisitions and financing activity and the lawyers involved.

Law Practice

Fox Rothschild hires noted TV lawyer

Philadelphia-based Fox Rothschild LLP added seasoned television lawyer Jody Simon to its Century City office Monday as the mid-sized law firm continues to expand its entertainment practice on both coasts.

Loeb & Loeb launches in Hong Kong through association

Los Angeles-based Loeb & Loeb LLP has launched an office in Hong Kong in association with a local law firm as it sets its sights on an economic recovery in China.

Solo and Small Firms

Bigger isn't always better

The loss of a major client in 1995 led Rosenfeld, Meyer & Susman to trim its ranks from 70 to 12 lawyers. But the firm's lawyers say shrinking operations helped them gain independence and diversify their client base.

Bankruptcy

Atwater could be California's next Chapter 9 case

The city of Atwater could soon become the fourth California municipality to declare bankruptcy in less than a year. Experts say it's a sign that cities are struggling but caution it's not the wave of bankruptcies that some have

date the estate and gift tax rate will increase from 35 to 55 percent.

If Mom and Dad are 65 and 60, the private annuity required is 4.6 percent (3.4 plus 1.2). However, the \$200,000 of distributable cash flow is 4.6 percent of only \$4,340,000. So Mom and Dad can enter into a part-gift, part-sale transaction: they give the children's trust of \$5,660,000 (\$10,000,000 minus \$4,340,000); then they sell the remaining \$4,340,000 for a private annuity. Mom and Dad are assured of receiving the \$200,000 for as long as either of them is alive. They will never run out of money. On the other hand, should they die prematurely, the children will realize a windfall: nothing will be included in the surviving parent's estate.

If only Mom, age 85, is alive, the required annuity rate is a staggering 17 percent (15.8 plus 1.2), and \$200,000 is 17 percent of only \$1,180,000. Therefore, a part-gift, part-sale transaction as described above will not work since the required gift (\$10,000,000 minus \$1,180,000 equals \$8,820,000) will exceed Mom's \$5,120,000 gift exclusion. There are at least two ways to make this transaction work. First, what Mom views as being worth \$10,000,000 may not appraise at \$10,000,000. In most cases, the values clients give us are 10 to 30 percent higher than the appraised values. Second, if Mom contributes the building to a family limited liability company and sells membership interests to the children's trust, combined discounts for lack of control and lack of marketability should reduce the value by another 20 to 30 percent. As a result of these two steps the transaction may look like this: \$10,000,000 times 84 percent (to reflect the real estate appraiser's value) equals \$8,400,000 times 75 percent (to reflect the 25 percent entity level adjustments) equals \$6,300,000 minus \$1,180,000 (portion that can be bought for the private annuity) equals \$5,120,000, which equals Mom's lifetime exclusion.

What if the building is, indeed, worth \$10,000,000, and there are no valuation discounts? The \$1,180,000 private annuity portion and \$5,120,000 gift portion leave \$3,700,000 with which we must deal. At Mom's age 85 we might have the children's trust acquire the \$3,700,000 for a nine year interest only installment note at the current required interest rate of 0.93 percent, which will require annual payments of \$34,410. Assume Mom dies at age 90. There will be four years left on the note. Depending upon the then prevailing interest rates, that note will be discounted in value when included in Mom's estate.

Private annuities are not the right structure for every family situation. However, when parents have compromised life expectancies and need the assurance that their money will never stop, private annuities should be closely considered in trying to reach an attractive estate tax result.

[Previous](#) [Next](#)

DON'T MISS CHAMPIONS OF JUSTICE

EVERY SATURDAY AND SUNDAY ON THE FOLLOWING STATIONS:

KRLA 870 LOS ANGELES
KFWB NEWS TALK 980AM
LOS ANGELES
KCBQ 1170 SAN DIEGO

KTIE 590 SAN BERNARDINO
KTKZ 1380 SACRAMENTO
KDOW 1220 SAN FRANCISCO



Hosted by:
**THOMAS V.
GIRARDI**

Listen to the
Finest Legal Minds
in California
Talk about the Law

Large Firms Rolling capital contributions and the Ginsu knife: Part Two

It shouldn't come as a shock that law firms active in the lateral hiring market want to distinguish themselves from Dewey. By **Ed Reeser**

Entertainment & Sports Why celebrities living outside California choose to die here



If anyone would like a reminder of why we need a federal right of publicity law in this country, let me offer up the new Marilyn Monroe decision as Exhibit A.

Litigation eDiscovery: Unsuspecting waiver of attorney-client privilege

There are instances when we already have the "golden goose" in our hands, and it remains only for us to lose it. By **A. Marco Turk** of CSU Dominguez Hills

Health Care & Hospital Law Court avoids ruling on applicable instructions for medical causation

The state high court abrogated the "release rule" and clarified hospital liability in medical malpractice cases, but it did not clarify the applicable instructions. By **Thomas Trapani** of Manning & Kass, Ellrod, Ramirez, Trester LLP

Law Practice Too long, didn't read

When I am advising on a complex issue, I am wary of giving the "two-sentence answer" that is more often being asked of me. By **Timothy Tosta** of McKenna Long & Aldridge LLP

Perspective Exposing flaws in our immigrant court system

The immigration system is a failed one, "Show Trials" author Peter Afrasiabi declares, one that has fallen short of guarantees of due process enshrined in the Constitution. By **Maurice Possley**

Tax Estate tax magic: private annuities

The scramble is on to take advantage of the gift tax exclusion before it is reduced on Jan. 1. On that same date the estate and gift tax rate will increase from 35 to 55 percent. By **Bruce Givner** and **Owen Kaye** of Givner & Kaye APC

Judicial Profile Diane B. Altamirano

Superior Court Judge Imperial County (El Centro)

ADR Provider

Russell M. Bostrom, Judicate West Mediation sessions typically begin with what Russell A. Bostrom calls the "offended/insulted" stage. But attorneys say that initial bluster doesn't get in Bostrom's way.

Government Judges group and judicial branch fight over information

Frequently at odds, the Alliance of California Judges and state judicial branch leadership are now fighting over access to public records about branch business.

CHAMPION

KRLA 870, KFWB News Talk 980AM, I