

Asset Protection is a Matter of Trusts

Little-known tax-deferral program can save you money and give a boost to your retirement

It's no secret that the Bay Area real estate market is on fire. What many don't know, however, is how much higher home values increase Uncle Sam's cut of a home sale. It's not uncommon for homeowners to owe hundreds of thousands of dollars in capital gains taxes, depreciation recapture taxes and other costs after they sell their house.

So how does one sell their home or other highly appreciated assets, without incurring such steep tax consequences?

Though it's been around for decades, few people know about a capital gains tax deferral program known as the private annuity trust (PAT). In practice since 1954, the program allows investors to transfer the asset they would like to sell — real estate, stocks, bonds, businesses, art or collections, for example — into a PAT, which in turn guarantees them fixed income payments for the rest of their lives from their beneficiary. The PAT also allows them to defer tax liabilities, create a lifetime retirement income and eliminate estate taxes, all with the blessing of the IRS.

There are many benefits to PATs, including no capital gains taxes, state taxes or depreciation taxes upon sale of asset, no estate taxes due upon taxpayer's death and the elimination of property management headaches. Other benefits include the maximization of Medicaid benefits by protecting family property from recovery of past nursing home expenses. A PAT protects property in legal disputes and avoids the expenses and hassles of probate court.

But the primary focus of a PAT is on funding retirement while protecting the estate and assets that have taken a lifetime to build.

"Generally if people sell a highly appreciated asset, they must pay capital gains taxes on that sale almost immediately," said Larry K. Weiss, CPA, CSA. "With a PAT, you do not eliminate the capital gains tax but rather pay the tax over many years. The second important benefit is that when you transfer this asset to your private annuity trust, the asset is no longer part of your estate. For people who may face an estate tax, the top estate tax rate in 2006 is 46 percent."

Steven J. Kopff, CPA, of Steven J. Kopff &



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Associates in San Francisco, said what makes the private annuity trust attractive is that the property owner does not pay tax on any of the gains until the annuity payments are received.

"The amount and number of annuity payments are determined by the Internal Revenue Service life expectancy tables," he said. "There are no interest charges, and no penalties are charged by the IRS for the deferred payment of taxes of the gain over the life of the annuity. Additionally, the proceeds from the sale of the property left in the trust can be invested and yield greater income than had the property been sold outside the trust and fully taxed. The reason for this is the investment base, or how much capital is left over to invest, is greater under the private annuity trust scenario."

But though PATs may seem like a simple solution to burdensome tax liabilities, they're not for everyone and should not be undertaken without a professional guide.

"There are a million rules with PATs," said Kevin McBarron, president of the National Association for Private Annuity Trusts in Irvine, Calif. "You need good attorneys drafting them and good CPAs working with your money. People often call NAPAT because they've done a PAT incorrectly before, and they didn't understand all the idiosyncrasies. These are very complex and there's no five-minute phone call that can explain everything."

McBarron cautions that PATs also have their drawbacks, one being that it is an irrevocable trust.

"The principal is no longer at your disposal," he said. "A PAT is perfect for someone who has more than enough income for life. These are people in their 50s and 60s and above, because they cannot use that money again in their lifetimes."

For this reason, PATs are most often arranged between family members, although that's not a requirement. The settlor is the person putting the asset into the trust. The beneficiary is usually their child. The trustee is the person who manages the assets in the trust, usually the beneficiary.

An alternative to the PAT is to do what is known as a form 1031 Exchange, where the sale of one property is rolled into the next property so there's no estate tax due. The problems

with this are that the seller is still in the real estate bubble if there is one, and that the property is part of the seller's estate. If the seller dies, he or she still owes that 50 percent tax.

According to Robert Binkele, founder and CEO of Estate Planning Team and www.mypatplan.com in Palm Desert, Calif., the largest provider of PATs in the country, the 1031 Exchange of like for like has been a good investment alternative for a long time, but now the cap rates are so low that it doesn't always make sense.

"You have 45 days to identify properties you want to buy and then 180 days to close it," Binkele said. "This poses a problem of rushing into buying properties, selling yours high and then buying high again. You're just trading dollars, and if the real estate bubble bursts the risk of failure is high."

According to Kopff, there are some creative ways of designing PATs to maximize their advantage. "PATs have some flexibility to them," he said. "Assuming that the property owner does not need the proceeds from the sale right away, the annuity payments can be deferred up until the PAT holder is 70 and a half years old. This will defer the tax even longer and allow the bigger investment base to earn more investment income. Other creative plans could have the trust issue more than one annuity at the outset — one would have payments begin immediately and the other would be deferred."

Other points of interest regarding the PAT are that one can borrow money from the trust on a secured basis. One can also use a portion of the proceeds to reinvest at a later time.

"If you're going into escrow right now, a PAT can be set up in as little as one week," said Binkele. "Property owners can expect to pay between \$4,500 and \$15,000 to set up a trust, depending on capital gains."

PATs are just one in an array of programs designed to protect your assets, and prospective clients should consult a qualified tax professional to review the different options on the sale of their property prior to investment. But if you're nearing the end of your work life, you just might find a PAT is the best way to keep our gains working for you.