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Private Annuity Trusts Can Help Defer Taxes

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Question: I'm interested in private annuity trusts, which you wrote about previously as vehicles that can help real-estate owners defer capital-gains taxes on property sales. If a real-estate owner can sell property to a private annuity trust and the trust can turn around and sell to a third party, how does one get around the rule in the Internal Revenue Code, section 453(e) that says: "If any person disposes of property to a related person and before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property, then ... the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition" ?

-- Margaret, Louisville, Ky.

Answer: First, let's decipher the Internal Revenue Code. If a person sells a property to a related person and then that related person sells it to a third party before the original seller gets proceeds from the first sale, then the proceeds the related person gets should be treated, capital-gains tax wise, as received by the original seller. So if you sell a property to Mr. Smith and Mr. Smith doesn't pay you all the proceeds all at once, but in installments, and Mr. Smith sells the property to Mrs. Jones before you receive all the proceeds from your sale to Mr. Smith, the proceeds Mr. Smith receives from Mrs. Jones would be considered capital gains on your original sale so you would owe capital-gains tax.

According to Richard T. Williamson, author of "Selling Real Estate Without Paying Taxes" (Dearborn Trade Publishing, 2003), the answer to your question is: You don't have to get around the rule. The IRS rule applies specifically to installment sales, where the owner sells a property on a long-term payment plan with the property as security for the debt. Installment sales stretch out capital-gains taxes so the seller doesn't incur a huge upfront tax bill.

A private annuity trust, on the other hand, is a trust in which the property owner transfers ownership of the property to a trust before completing a sale to a buyer. The trust pays the owner for the property, not in cash, but with a special payment contract called a private annuity that stipulates that the trust will make payments to the owner for the rest of his or her life - essentially in installments. The trust often names the property owner's children as beneficiaries. The trust can then sell the property to the buyer, getting cash for the property.

In a normal sale, the seller would immediately pay capital-gains tax on the full value of the property. Since the private annuity contract calls for payments to be made over the seller's life, the seller is taxed on payments only when they are received, instead of all upfront.

So if you transferred ownership of a property to the trust and the trust sells it to Mr. Smith, proceeds from the sale go to the trust, which can use the proceeds to make investments. The trust is required to make fixed payments to the investor for the rest of his or her life. The amount of the payments is determined by Internal Revenue Service life-expectancy tables.

Even if the rule were a consideration or a concern when using a private annuity trust, "the IRS definition of related party would not apply because of the way private annuity trusts are structured," says Mr. Williamson, an estate and capital-gains tax-planning attorney in Long Beach, Calif. With a private annuity trust, he explains, the property owner is the originator of the trust but when the property is transferred, he becomes an annuitant or creditor, not a beneficiary or fiduciary. The structure of trusts within the rule's definition of related party are those in which the property owner is also a beneficiary or a trustee, which is not the case in private annuity trusts.

The National Association of Financial & Estate Planning in Salt Lake City can help you understand the ins and outs of private annuity trusts. Technical and legal information, for instance, is available in an association publication called "Private Annuity Legal Package." For more information, visit the association's Web site, www.nafep.com, or phone: 801-266-9900.

-- Mr. Smith is a staff reporter for The Wall Street Journal. His "Building Value Q & A" column appears each month exclusively on RealEstateJournal. [Click here](#) to e-mail him a question about investing in real estate.