The Annuity Approach

Exchanging Your Business For an Annuity Retirement Approach

By James Welbier

For a wall and ceiling contractor looking at the advantages of selling his business in exchange for a “private annuity,” the device is attractive enough to warrant attention.

Of course, it can be useful in some situations and not so beneficial in others so an awareness of all of its advantages and disadvantages is important.

Typically, the exchange of a business for a private annuity involves a son or daughter who is taking over the business. A private annuity is usually defined as the sale of a property (such as a contracting business) to be paid by a person other than an insurance company.

Another option is where there exists stockholders a corporation may redeem a seller’s stock in exchange for a private annuity. This leaves the other stockholder(s) in control of the corporation.

Great Advantage Is Life Income

The major advantage to a private annuity is that, unlike a straight sale, the seller gets a guaranteed life income from the transaction. And this income will continue regardless of how long the seller lives.

The seller depends on the business values for a retirement income for himself and his spouse. This is why the annuity approach is, in many cases, superior to the outright sale.

If purchased from an insurance company, an annuity provides a guaranteed income for a specified period at a certain premium or outright price. The payout is calculated on the basis of the amount of the premium payment plus the interest it earns minus the insurance company’s mark-up.

A private annuity merely avoids the insurance company involvement and consequent added cost factor.

There are other advantages to the private annuity approach. Should the seller die ahead of his normal life expectancy and thus not use up the annuity payments, the transfer will exclude the business value from the estate of the seller, thus reducing estate taxes.

On an income tax basis, capital gains taxes on the business sale are deferred over the period of annuity payments, similar to an installment sale.

And here, if the seller dies short of his normal life expectancy, the bulk of the gain may escape income taxes completely.

Annuity Approach Has Disadvantages

At the same time, private annuities are not all pure advantage. IRS regulations, for example, hold that a private annuity may not be secured.

Once a transaction is secured, it may be considered as an installment sale and is thus subject to different

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tax results. Securing the transaction means that the seller holds a mortgage or some other type of security which would guarantee payment of the annuity.

It goes without saying that in such an arrangement, the contractor-seller would be well advised to have total and complete confidence in the buyer’s integrity and ability to pay.

If the business, under the control of the new buyer, goes down the drain, so too does the annuity payments.

For this reason, the seller’s confidence must extend also to those who would inherit from the buyer in case of death. Admittedly, it’s a rather precarious position, so a contractor seeking a private annuity deal should make certain that the buyer is a person of substantial means.

There is another reason for the buyer to have sufficient means in relation to the amount of the annuity. This is to convince the IRS that the seller has not retained a prohibited life interest in the specific property.

When a contractor has more than one child and seeks to arrange a fair and proportionate share of his estate presents another difficulty.

This disadvantage can be overcome if the business is recapitalized so that part of the value is represented by voting shares and part by non-voting preferred or common shares.

Remember, though, that since only the voting shares will then be sold, the annuity will be reduced accordingly.

Also, the seller who is depending upon his business’ value for retirement income must retain the non-voting shares for income before bequeathing them ultimately to the other children. Understandably enough, such an arrangement will reduce the role and advantages that a private annuity offers.

Tax Aspects Need Careful Planning

Because of the complexity of the tax computation and planning, a contractor must work carefully with a good accountant and tax attorney.

Here is how the tax effect hits both seller and buyer.

For the seller, each annuity payment will consist of three elements: 1) return on investment (basis), 2) capital, and 3) ordinary income (interest).

Under the “depreciation recapture” rules, where depreciable property is transferred some of the capital gains portion of each payment will be taxed instead as ordinary income.

For the buyer, the interest element is not income tax deductible, and this can represent a rather substantial disadvantage when compared to an installment type purchase.

Where depreciable property is concerned, the buyer’s basis for depreciation is pegged on the actuarial value of the annuity promise. And this amount is later increased in line with any excess payments where the original seller outlives his life expectancy.

Of course, the business values represented by an annuity are immediately excluded from the seller’s estate and there is no question of inclusion even if the seller dies within three years.

This estate tax advantage, though, is predicated on the fact that the price of the business has been fairly determined, and that the subsequent annuity is based on published IRS actuarial tables.

There is also an assumption that the buyer has the financial means to make the payments, and that the seller retains no security interest.

Additionally, the seller should know that if he does not consume all of the annuity payments, any accumulated payments will be included in his estate.

So long, too, as the price has been fairly determined and the required IRS actuarial tables have been followed there is no problem from a gift tax standpoint.

While the private annuity approach is a viable mechanism for translating your business value into a retirement income, the balance-off of advantages and disadvantages is such that any wall and ceiling contractor should proceed only with expert advice.