

markets will. A Blackstone could re-leverage Maguire's portfolio at 80% or more instead of its current 56% debt-to-value, sell some buildings and make a profit.

Another alluring buyout target is hotel REIT Sunstone, trading at a 9% discount to NAV. The company has a solid collection of Hyatts and Hiltons in places like New York and California, and for the first nine months of 2006 its adjusted FFO was up 21%. But after the company missed its quarterly earning target by 6% because of renovation costs at several Washington, D.C. hotels, investors knocked 9% off the stock in two days; only recently has it inched back above its 52-week low of \$26. Who needs that pressure? As a private company, Sunstone could make renovations without worrying about a stock hit.

Two apartment REITs that make our list are Home Properties and Colonial Properties. Trading at a 4% discount to NAV, Colonial is the better buy. Focused on the Southeast, Colonial has been selling off offices and shopping centers to buy more apartments. During the transition the REIT's stock has consistently underperformed, making it cheap for an acquirer looking to collect apartments now that rents are improving.

The other strategy, to buy strong REITs that are not obvious takeover bait, is favored by Green Street's John Lutzius. "Takeout candidates tend to be B students," says Lutzius.

Public Storage is the largest self-storage company in the nation, with 2,100 centers. It has shown the highest steady earnings growth of any REIT on our Gold List with five-year annualized growth in adjusted FFO of 11.7%. AFFO is expected to grow another 26% this year. Because the company is trading at a 47% premium to NAV it's unlikely to attract the attention of any private equity firms. The company should see cost savings from its recent \$5 billion purchase of competitor Shurgard.

Another sterling REIT is Simon Property Group, the largest shopping center trust, with 286 U.S. malls. So far private equity firms have shown little interest in retail REITs, which trailed the overall REIT sector by five percentage points last year. Simon's earnings have grown a healthy 8% annually for the past five years. **F**

TAXING MATTERS

# Deferral Games

Take your choice when you sell an appreciated asset. Pay a 15% tax, or buy a convoluted tax shelter that will bleed you with fees and expose you to big trouble with the IRS | By Ashlea Ebeling

IT'S AMAZING WHAT CONTORTIONS people will endure to avoid paying a small tax. Long-term capital gains have a maximum federal tax of 15%. To dodge that people will buy tax shelters that come with huge commissions (up to 10%) and setup fees (\$20,000), sometimes agree to a prolonged 2% annual "management" fee for holding the proceeds, run the risk of getting nailed for back taxes and interest, and put themselves in a financial glue trap that they might be able to escape only by paying the shelter promoter yet more money.

Here's a novel idea: Just pay the 15%. Put what's left in a nice, safe municipal bond.

The tax dodge in question is an "annuity trust." Instead of selling an appreciated asset (say, commercial real estate or a business) for cash, the customer transfers the asset to a trust. The shelter promoter sells the asset and uses

the proceeds (minus the vigourish) to pay a lifetime annuity to the shelter participant. Then the shelter promoter whips out a 1969 Internal Revenue Service ruling declaring that since the value of the annuity isn't known, the gain can't be taxed up front. If the scheme works, the taxpayer doesn't escape the gains tax altogether; rather, he declares a portion of each annuity payment to be capital gains and pays tax on that.

Note that we said "if." In October, citing taxpayer abuses, the IRS proposed new rules that would put an end to this gambit by taxing the entire gain immediately, with the annuity's value set by IRS tables. The key rule would apply only to transactions after Oct. 18, 2006.

The tax shelter industry is not happy. E. Anthony Reguero, a Lake Forest, Calif. financial planner who has organized a campaign against the new rules, estimates that 5,000 folks a year were



putting \$4 billion of assets into these trusts. "The IRS dropped a bombshell on us," complains Steven B. Gorin, who helped write comments for the American Bar Association's trust law section arguing that the IRS should attack "perceived abuses" without ending the gains deferral.

But even if the IRS bombs the annuity trust into oblivion, there's still work for the middlemen: untangling existing tax shelters. Some lawyers and financial advisers have latched on to the new business of helping folks get out of annuity trusts. "If you have one, you ought to wind it up, because you'll likely save a lot of money," says Kevin McGrath, an Atlanta tax lawyer and longtime annuity trust skeptic (see box). The fees, that is, are sometimes so onerous and the tax results so bad (some of what you get from the trust is doubly taxed and taxed at rates of up to 35%) that escaping a trust might be worth paying a ransom to the promoter, plus the capital gains tax you were avoiding in the first place.

Some taxpayers who bought into the iffiest schemes could have bigger problems than the fees. In some deals the seller of the property effectively controlled the trust he sold to—a setup the IRS has successfully challenged as a sham. Most of the 300 clients of annuity trust promoter David J. Orr (just sentenced by a Utah federal judge to five years in the slammer) have been called in for audits. Last August a Senate investigating committee alleged the billionaire Samuel and Charles Wyly family used private annuity trust deals with offshore shells they controlled to avoid taxes on hundreds of millions in stock options and investment gains. The Wylys' attorney, William Brewer, says his clients believe everything they did was appropriate.

Vendors of yet more tax-deferral schemes are ready to pick up where the annuity trust business leaves off. Each entails the risk of engaging the taxpayer in a costly fight with the IRS; each involves fees for middlemen and advisers that can exceed the value of the tax savings.

One classic ploy is the Section 1031 exchange, in which you swap one piece of investment property, like an apartment building, for another and roll over your gain. There to help you out: lawyers,

accountants and so-called exchange accommodators, who engage in complicated three-way trades so that you can get the new investment property of your choice. Each helper costs money. Maybe you'd be better off just paying the tax, even though it will be a bit more than 15% on real estate (the tax rate is higher on the portion of your gain attributable to depreciation writeoffs).

Another option is an installment sale. When you sell your strip mall or your business, you take an IOU from the buyer for some of the purchase price. In that case you report the capital gains only as fast as the money comes in. Two problems here: The buyer might default, and a portion of each deferred payment is treated as highly taxed interest income. Who needs that?

A variation on the installment sale involves an insurance company like Allstate or Prudential in the middle. Mark Wahlstrom, a broker in Scottsdale, Ariz., says it appeals mostly to less wealthy folks seeking "certainty and security." One

recent customer was selling his auto body shop for \$700,000.

In fees and tax uncertainties the insurance-enhanced installment sale is a close match for the discredited annuity trust. Here's the recipe for the Allstate product, on the market since 2005. The asset buyer sends a check for the full purchase price to an Allstate subsidiary in Barbados. That buys an annuity whose payouts go to the asset seller. It's an open question whether the IRS will treat the transaction as an installment sale eligible for tax deferral, warns Atlanta attorney McGrath.

If the IRS uncertainty doesn't give you pause, maybe the fees will. The broker gets a commission of between 0.1% and 4%. The return built into the annuity is a measly 4%. And remember, the deal doesn't buy you a tax exemption; all you get is a deferral.

For those people who get a special thrill out of raising their risk of a tax audit, there's a new scheme from the NISS Foundation (formerly the National Installment Sale Service) in Kitty Hawk, N.C. Founder Anthony March, who also runs the National Private Annuity Trust, says he's got a legal way to make the installment payments largely tax free: The seller transfers the asset to March's charitable "foundation" and gets back payments. Here's the warning from Jay Adkisson, a lawyer who runs a Web site, Quatloos.com, tracking flaky tax shelters: "The IRS hates abusive things involving charity."

Then there's the National Association of Financial & Estate Planning, a firm in Salt Lake City that peddles the "self-directed installment sale." Here a partnership and a trust interposed between the seller and buyer make the transaction supposedly tax deferred. Lots of luck. Some years ago the Tax Court ruled that a private annuity trust, set up by the aforementioned David Orr with the help of Nafep, was a sham. Nafep says it provided only technical assistance in establishing the trust. **F**

## ESCAPE

IF YOU'VE SET UP A PRIVATE ANNUITY TRUST, YOU may want to look for an exit plan. Steven Roth, president of Wealth Management International in Century City, Calif., has helped several investors unwind these trusts, including one client who had put in assets worth \$12 million. "In each case, it would have been an economic disaster if they had stayed in," he says.

If the promoter who sold you the scheme is the trustee, you may have to buy your way out, since he won't want to give up his continuing fees. But Roth says that when challenged, three trust promoters and one tax lawyer all caved in and made his clients whole in settlements.

To exit from a trust set up between 2003 and 2005, you amend your old tax return for that year and pay back tax plus nondeductible interest on the tax. Still, by unwinding the transaction now, you benefit from the low 15% cap gains rate, due to expire at the end of 2010. If the trust bought a commercial annuity, demand a refund on the grounds it wasn't a suitable investment. —A.E.