Practice Alert: The Public Life of a Private Annuity (Part 1)

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The private annuity as a financial planning tool surfaced periodically over the past 75 years. Its utility fluctuates in concert with rates of income taxation and interest, the former imposed on the payor (Payor) and the latter set by the Internal Revenue Code of 1986 (Code) for use in calculating the benefit. Presently, both tax and interest rates are lower,[1] leading to reexamination of this well established tax and estate planning tool.

The principal benefits of a private annuity include: (1) removing assets from the annuitant's (Annuitant) gross estate for federal estate tax purposes, without the payment of gift tax as a toll charge and while retaining an income; (2) spreading the taxation of capital gains over the life expectancy of the Annuitant when exchanging appreciated property for the annuity; and (3) delivering the appreciated property to the Payor with a new—exchange value—basis, permitting its immediate sale without capital gain taxation to the Payor.

Private annuities, if used artfully, may be the most powerful weapon available today for postponing income taxes, avoiding wealth management and investment worries, and preserving a source of income.

A private annuity is an agreement between two parties, neither of whom (or which) is in the business of issuing annuities. Under the agreement, one party (the Annuitant) transfers property to the other (Payor) in exchange for the Payor's promise (usually unsecured) to make periodic payments in specific amounts to the Annuitant, typically for the Annuitant's lifetime: (e.g., father gives son the family farm in exchange for son's promise to pay father $1,000 per month for life). The private annuity differs from grantor-retained interest trusts of one stripe or another in at least one respect: the tax objectives are substantially satisfied whether or not the annuitant lives out his or her life expectancy.

The defining characteristics of the private annuity include an agreement that establishes the Annuitant as a general creditor of the Payor.[2] The parties are usually individuals who are related to each other, although other entities are permitted. Private annuities can be arranged between a corporation and an individual, a trust and an individual, or between an estate and a corporation (with the estate exchanging property or stock for payments by the corporation measured by the life of an estate beneficiary). Also annuities have been used between a corporation and a retiring shareholder under a stock redemption arrangement, with annuity installments in lieu of the more usual lump-sum payment.

The Payor must not be a person who is engaged in the business of issuing annuity contracts, even

occasionally. If so, the difference between the present value of the annuity on the date of exchange (set by Treasury regulations)[3] and the Annuitant's basis in the property is immediately recognized as a capital gain. (Rev Rul 62-136, 1962-2 CB 12)

As soon as the private annuity agreement is executed, the Payor acquires legal title to the transferred property and may sell or otherwise dispose of it as desired. The Annuitant could retain a security interest in the transferred property, but doing so leads to recognition of any gain on the exchange. (Estate of Bell, (1973) 60 T.C. 469) This is not an issue, of course, when the exchange property is cash or a high-basis capital asset.

The periodic installments must be in the nature of an annuity—the systematic liquidation of principal and interest over a specified period of time. For the desired estate tax results, the annuity should continue for the Annuitant's lifetime, no matter how long, but not one day more. This, of course, has an economic impact on the Annuitant and Payor quite apart from tax considerations. The annuity installments are ordinarily level for life, but may be inflation-adjusted so long as the present value at the date of exchange is the same. (PLR 9009064)

A private annuity should not be confused with a life estate. It provides a predetermined income lasting for the lifetime of the Annuitant, whereas a life estate does not guarantee income, and pays only as much income as the supporting principal earns. With a life estate, the transferor transfers the property but retains an interest in it. This is not the case with a properly arranged private annuity. Internal Revenue Service (IRS) has argued that the purchase of a private annuity constitutes a transfer with a retained interest such as will cause the property to be brought back into the gross estate of the Annuitant under Code Sec. 2036(a) , as if it were a life estate. The courts, however, have firmly rejected that contention, based on the character of the private annuity transaction as a purchase and sale at fair market value. (Stern v. Commissioner, (1986) 650 F. Supp 16 (1986); see also Estate of Fabric vs. Commissioner, (1984) 83 TC 932 , 935)

How is a private annuity used? When the need is to defer income tax on the sale of property, the private annuity may prove useful on the right facts. Income tax brackets are steeply progressive, so spreading the gain over more than one taxable year may keep the Annuitant in a lower bracket than would be the case if the gain was all recognized in the same year.

The private annuity may be used as a "last chance retirement fund." For the Annuitant who never prepared for retirement, a private annuity may provide economic security in a variety of ways. The annuity may be used to create a market for an otherwise unmarketable business, or assist in the sale of undeveloped land.

Avoiding gift and estate taxes is always a popular use for a private annuity. Taxable gifts will use up part of the donor's lifetime (unified) applicable exclusion amount, and increase the tax payable on death if the date of death value of the estate exceeds the applicable exclusion amount remaining. The use of a private annuity, however, accomplishes substantially the same end, without characterization as a gift, and without use of the Annuitant's lifetime exclusion. The private annuity involves a bona fide purchase. Therefore, the Annuitant may remove unlimited amounts from the estate without gift tax.

Shifting appreciation to the next generation is another attraction. When a valuable business shows promise of continued growth, the owner approaching retirement may wish to exchange it

with the owner's children for a life annuity. This removes it from the Annuitant's gross estate, replacing it with annuity income of equal value, adjusting basis to what amounts to fair market value in the hands of the children as Payors. This, in turn, shifts the post-exchange appreciation to the next generation. Congress attempted in 1990 to eliminate such appreciation-shifting techniques by enacting Chapter 14 of the Code and repealing Code Sec. 2036(c). The techniques addressed by the new Chapter 14, however, are gift arrangements requiring retention of an interest in the gift property.[4] The private annuity is a purchase. If made at fair market value, the undesirable effects of Chapter 14 are avoided.

Trading capital for income is another use. The prospective Annuitant may own property producing little or no income (e.g., unimproved real property). Just as often, that property has appreciated substantially. Rather than keep it in order to deliver it to the children at the stepped-up basis acquired at death,[5] the Annuitant may exchange it for a private annuity from the children. The children get it with the current fair market value as its basis (so they can sell it without capital gain taxes and redeploy the proceeds into income-producing investments). The Annuitant thereby converts the potential estate tax burden to a life income.

Basis in the hands of the children (as Payor) is the total payments paid to Dad (the Annuitant) to the date of sale, plus the then-present value of the remaining payments. Thus, if the Annuitant's life expectancy on the date of exchange is 12.5 years (father's life expectancy at age 75 under Reg. § 1.72-9 , Table V), the annual installments are $14,042 and the children immediately sell the property, basis for computing gain is $175,525.

To extend the example, if the property is depreciable, such as an apartment building, and if payments were made for 10 years before the sale takes place, the calculation would set up like this: payments made to date of sale are $140,420 ($14,042 × 10); present value of the remaining payments is $35,105 (2.5 × 14,042); the total is $175,525. Subtract the depreciation of $40,000, and the children's basis for computing gain on sale is $135,525.

Because of the dramatic results in terms of eliminating gift and estate taxes on the property exchanged for the annuity, the deathbed purchase leaps immediately to the fertile mind. As you might imagine, IRS takes a dim view of this type of estate planning. Rev Rul 80-80, 1980-1 CB 194 established a rule that the mortality tables are to be disregarded if death is imminent, thereby depriving the Annuitant of the tax benefits of an annuity conforming to all legal requirements. In attacking those transactions involving seriously ill Annuitants, IRS once contended that the payments were never intended. The United States Tax Court, however, was more generous. In *Estate of Fabric,* the Annuitant was scheduled for open heart surgery at the time the annuity was established. She survived the surgery by one year, five months. In affirming the legitimacy of the transaction, the Court stated the following:

> At the time of decedent's execution of the annuity agreement, it was not established that her maximum life expectancy was one year or less. In addition, while the decedent underwent open heart surgery five days later, she survived the operation by one year and five months. Furthermore, the uncontroverted testimony of decedent's physician was that as of late 1975, decedent should live several more years, possible even five more years.... The evidence demonstrates that the decedent's death was not clearly imminent or predictable at the time she entered into the annuity agreement. Only where death is imminent or predictable will

departure from the tables be justified.

In Estate of McDowell v. Commissioner, (1986) TC Memo 1986-27, the transaction was respected because, although the Annuitant's death was imminent, his life could be prolonged by treatment.

The regulations now provide more of a bright line test: if there is a 50% probability of death within a year, the Annuitant is considered terminally ill for these purposes. However, if the Annuitant survives for 18 months after purchasing the annuity, he or she is rebuttably presumed not to be terminally ill. (Reg. § 25.7520-3(b)(3))

To some extent the creditor protection afforded by the private annuity is derived from available state exemptions, but to a greater extent it arises from the nature of the device. The former may protect the income, and even accumulated annuity income. The latter is characterized as a contractual right to a stream of income, so the creditor may reach—at best—the installments as they are paid, one at a time. If the Payor is located outside the Untied States, it may prove impractical for the creditor to obtain jurisdiction by which to sequester even those installments.

If the Annuitant winds up in a bankruptcy proceeding, the trustee in bankruptcy will consider whether the private annuity is an "executory contract." (An executory contract may be rejected and the consideration brought back into the bankruptcy estate.) The answer turns on the definition of that term. To be "executory," there must be some "substantial performance" due from both parties to the private annuity agreement. (In Re Murexco Petroleum, (1991, CA5) 15 F.3d 833 , 839) After the Annuitant has paid for the annuity, the duties are no longer mutual; i.e., only the Payor owes a duty, so the contract is no longer executory. Therefore, the contract may not be rejected by the bankruptcy trustee, leaving that trustee only the power to claim the periodic annuity installments. If the Payor is located in the United States, jurisdiction is assured. If not, it may remain assured if the Payor is located in a common law jurisdiction recognizing the bankruptcy trustee's ownership of the annuity by operation of law. Most do, a few do not.

The income tax treatment to the Annuitant under a private annuity transaction varies, depending on the facts and circumstances. The Annuitant's investment in the annuity for purposes of computing the income tax exclusion ratio is the Annuitant's basis in the exchange property. If the exchange property is classified for income tax purposes as a capital asset (e.g., a commercial building), the Annuitant realizes a capital gain on the exchange in an amount equal to the difference between basis and the present value of the annuity received in exchange. But, if the promise to pay is unsecured, the exchange is classified as an open transaction, with capital gain recognized ratably over the life expectancy of the Annuitant. (Burnet v. Logan, (1931) 283 U.S. 404 ; Lloyd v. Commissioner, (1936) 33 BTA 903 ; Estate of Bell v. Commissioner, 60 TC 469) Therefore, each annuity installment is allocated partly to basis (recovered tax-free), capital gain (taxed at the preferred rate if long term), and ordinary income (taxed at ordinary income tax rates). If the annuity is a life annuity and the Annuitant survives beyond life expectancy, the capital gain portion of the annuity becomes taxable as ordinary income. (Rev Rul 69-74, 1969-1 CB 43) The portion allocated to recovery of basis, however, continues tax-free for life.

If the annuity becomes worthless (e.g., the Payor is insolvent), the remaining value (price paid less the value of annuity installments received, may be deducted by the Annuitant as a capital loss. (McInvale v. Commissioner, (1991, CA5) 936 F.2d 833 , 939)

Basis is affected by the existence of a gift interest in a private annuity. Specifically, a tax may be incurred if the fair market value of the property exchanged exceeds the present value of the annuity, or if it exceeds the amount the Annuitant would have paid an insurance company for the same benefit. The excess is the amount treated as a gift. If that happens, the Payor takes the Annuitant's basis in that part of the property, reducing overall basis in the Payor's hands. This impacts both depreciation/amortization deductions available to the Payor and gain on later sale.

> **Illustration:** Assume the Annuitant is 65, and she transfers $100,000 to her child in exchange for a private annuity. The annuity factor is found in IRS Publication 1457, "Actuarial Values-Alpha Volume." Here, the annuity factor is 7.1213, assuming an interest rate of 10% under Code Sec. 7520 (Table S 10.10). The annual annuity payments should be $14,042. Therefore, if the annuity payments are less, the excess value is a gift.
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> If the annual annuity payments are set at $12,000 instead of $14,042, the gift is $14,542, calculated as ($14,042 -- $12,000) × 7.1213. The way to deal with it is to switch from a one-time gift of excess value to a full-value annuity payment level from which annual gifts falling with the gift tax annual exclusion amount may be made.

Interest may be imputed to certain debt instruments under the original issue discount rules. (Code Sec. 1271 - Code Sec. 1275) They do not, however, apply to annuities—including private annuities—if payment depends "in substantial part" on the life expectancy of one or more individuals. (Reg. § 1.1275-1(j)(1))

If the promise to pay the annuity installments is secured (e.g., as with a deed of trust), the result is different: any capital gain must be fully recognized in the year of the exchange. As noted earlier, this is not an issue when the exchange property is cash or a high-basis capital asset.

Private annuities serve to remove the asset from the Annuitant's gross estate for estate tax purposes. Upon the Annuitant's death, the payments stop, leaving no remaining value to tax. If at death there is a surviving spouse and the annuity is structured to continue for the lifetime of that survivor (joint and survivor annuity), the marital deduction permits deferral of any estate tax on the value of the annuity payments remaining at the first death. (Code Sec. 2056) On the death of the survivor, the annuity term expires, leaving no remaining value to tax.

The property for which the annuity promise is exchanged is transferred to the Payor, and the promise of that Payor is extinguished at the death of the Annuitant.

Property is included in the gross estate of a decedent for estate tax purposes only if held at death or transferred at that time (Code Sec. 2033, Code Sec. 2036, Code Sec. 2037). The private annuity transfer takes place during lifetime, leaving nothing to transfer at death.

Whether the Annuitant is treated as having retained an interest in the property exchanged for the annuity is based on the substance and effect of the transaction, not on the subtleties of draftsmanship. (Lazarus vs Commissioner, 58 TC 854 (1972), aff'd (1975, CA9) 513 F2d 824, 829) Several factors are to be taken into account; no one of which controls the result. The Payor must be personally liable for the annuity payments, the annuity payments should not be an encumbrance on the property exchanged, and the amount of the annuity installments should have no relationship to the income from the property exchanged. Other factors considered include the

following:

Transfer of all dominion and control over the property from the Annuitant to the Payor. The total absence of security for the promise to pay, including reversion of the property on default, escrow accounts, and other devices.

The documentation must be consistent with the notion that an annuity was intended.

The Payor must be both free and able to sell, assign, transfer, and convey the property exchanged for the promised payments.

The annuity payments must be based on the Treasury Regulations for Code Sec. 7520.

The Annuitant should not retain control over the property, its investment, or the investment of its sale proceeds.

Private annuity settlement options include annuity payments for the life of the Annuitant, for a specific period of time, for the lifetimes of two persons and the survivor, and for life with the refund of any principal remaining upon premature death paid to a named beneficiary. As noted above, the annuity installments may also be level or inflation-adjusted. To the extent a benefit is payable on death of the Annuitant, that benefit constitutes an asset included in his or her gross estate. (Code Sec. 2039(b))

There are income tax consequences for the Payor. There is no deduction for payments made to the Annuitant. (Rev Rul 72-81, 1972-1 CB 98) They are deemed payments on the purchase price of the property. Also, if the property exchanged for the annuity is a wasting asset, the depreciation/amortization deductions are adjusted in accord with the basis adjustment in the hands of the Payor, as discussed earlier. (Code Sec. 167(a)(2)) This is particularly important where the property was fully depreciated/amortized by the Annuitant prior to the exchange.

Gift tax may be imposed on the private annuity transaction if the values involved (value of the property versus value of the annuity) do not match. These sometime unexpected, and certainly unfavorable, consequences should be avoided unless part of a larger plan. If the value of the annuity exceeds the fair market value of the property exchanged, the Payor is deemed to make a gift to the Annuitant with every annuity payment.

As to estate tax, remember that the obligation to make annuity payments does not attach to the property exchanged: it is personal to the Payor. Thus, even if the property is sold after the exchange, the Payor's obligation remains, and the Payor's estate receives an estate tax deduction in a like amount. If the Payor dies before the Annuitant, the annuity obligation continues as a claim against the Payor's estate. The then-present value of the remaining annuity payments sets the amount of the estate tax deduction for that claim. (Code Sec. 2053(a)(3)) If, on the other hand, the Annuitant predeceases the Payor, there is no remaining obligation, and thus no deduction. Of course, if the Payor dies still owning the exchange property without respect to the timing of death between the two, and except for exchange property classified for income tax purposes as "income in respect of a decedent," the Payor's estate receives a new basis equal to that used in reporting the federal estate tax. (Code Sec. 1014)

The generation-skipping transfer tax (GSTT) applies not only to trusts, but to "trust equivalents." (Code Sec. 2611(a)) Included among the latter are "insurance and annuity contracts." (Code Sec. 2652) That possibility notwithstanding, a GSTT private annuity is rare.

Footnotes:

[1] In 1991, the rate was 11%. As of November 2002, the rate was 3.6%

[2] In Re Baker's Estate (1942) 345 PA 308 , 26 A.2d 202 , where a private annuity agreement was held enforceable even though the transferor-Annuitant died prematurely

[3] The present value of a private annuity is determined under the IRS tables for valuing limited interests. (Rev Rul 62-137, 1962-2 CB 28) These tables appear in Reg. § 20.2031-10(f) and Reg. § 25.2512-9(f)

[4] Code Sec. 2701 and Code Sec. 2702 are predicated on a gift with a retained interest by the donor

[5] Code Sec. 1014

Practice Alert: The Public Life of a Private Annuity (Part 2)

1. *Part 1 of this two-part article appeared in the Newsstand e-mail of 12/06/04. Part 1 provided an in-depth description of the private annuity, a look at its use in a variety of circumstances, and a discussion of the various ramifications from its use. Part 2 of this article provides suggestions for structuring a private annuity and practical considerations in evaluating its use in estate planning. [For the readers convenience, Part 1 is reproduced at the bottom of this email].*

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The ideal Payor is a mature, financially responsible and trustworthy person with a high income. In the real world, however, the Payor is usually an average-income adult child of the Annuitant, with or without the other attributes. Here are a few ways to make it easier for the Payor to pay the installments:

(1) Timing helps. The Annuitant should purchase the private annuity as soon as it makes economic sense. Annuity installments are lower where the life expectancy is longer, bringing the obligation more within the likely investment return on the property exchanged. A benefit by serendipity is that it also spreads the Annuitant's capital gain (if any) over more years.

Illustration: For example, husband and wife, both age 55, exchange a $1 million apartment building with an adjusted basis of $200,000 for a joint and survivor life annuity of $55,320 per annum. The annuity income is reported as: $5,900 tax-free recovery of basis, $23,599 as capital gain, and $25,821 as ordinary income. The annuity obligation amounts to 5.5% of the exchange property value, bringing it within the probable after-tax average annual return on investment.

(2) Selection of the payment option is the tool of choice. Assuming that the transaction is not aimed at installment sale treatment, in which case, a self canceling installment note would be used, the highest payout rate is for the lifetime of the Annuitant, and nothing more. The payout rate is reduced if the agreement provides for a guaranteed minimum number of payments called a "period certain." The payout rate is reduced more if it is paid for the longer of two lives (e.g., joint and survivor).

(3) An inflation-adjusted annuity lowers the installments in the early years. The only law recognizing a private annuity with this feature is a private letter ruling (PLR 9009064), but it serves to convey the IRS's view for our purposes. Reduced installments in the early years allows the Payor to build up an accumulated income reserve, thereby reducing the prospect of funds exhaustion in later years.

(4) If the selection of the payment option does not bring the payout rate within available income from the asset exchanged for the annuity, the Annuitant should consider first placing the property in a limited partnership, allocating 99% to the limited interest and exchanging

that interest for the annuity, taking a valuation reduction of 15% to 40% for lack of marketability and lack of control. By reducing the value of the interest exchanged for the annuity, the required payout rate is reduced.

(5) If it is economically feasible to do so, all or part of the exchange property may be sold by the Payor, who could then invest the proceeds in higher-yield investments or hold them in a more liquid form to fund the annuity installments.

(6) On the right facts, it may prove attractive to set the annuity installments at full exchange value no gift imputed, but return part of each annuity payment as a gift to the Payor. This enables the Annuitant to make use of the annual gift tax exclusion, perhaps never incurring a taxable gift and removing those amounts from the gross estate for federal estate tax purposes. (Code Sec. 2503(b) and Code Sec. 2035(b)(2)) This also allows the Annuitant to judge each year how much may be needed for living expenses, and to adjust the gift amounts accordingly.

(7) Borrowing on the security of the property may help. The Payor could borrow money, using the exchange property for collateral, in order to raise cash from which to pay the annuity installments, or in order to redeploy the proceeds into higher-yielding investments. If that would lead to negative cash flow, a reduced annuity payment by encumbering the property in advance of the exchange could lead to a workable result. If the loan is greater than the Annuitant's basis at the time of the exchange, it may, or may not—depending on the facts—cause recognition of the gain on transfer.

The issue is: will the private annuity prove useful in causing ratable recognition of capital gain? The answer turns on the nature of the loan.

As context, remember that ratable recognition of gain is a product of the unsecured promise to pay the annuity. Because it is unsecured, the law concedes that the full gain should not be recognized in the year of sale, because there is a possibility that the full amount will not be paid. This is called the "open transaction doctrine," and was first recognized in 1934.

The exchange property may be subject to recourse debt, nonrecourse debt, or sold with seller financing. Nonrecourse debt (no borrower liability for deficiency on foreclosure) and seller financing are covered by the regulations, and the excess will be recognized in the year of sale.

So, we instead analyze the effect on *excess recourse debt.* Recourse financing leads (on sale) to realization of capital gain or loss. The treatment is addressed at Code Sec. 1001 , where we see that gain or loss is computed with respect to basis, the amount realized is the consideration (including reimbursement for property taxes), and it is subject to variance for installment sales and like-kind exchanges.

"Realized" gain means gross proceeds from a sale or other disposition. "Recognized" means realized and included or deducted (gain, loss, ordinary income), because it is not deferred or excluded.

Gain or loss may be deemed realized: (a) upon transfer in satisfaction of a debt obligation

(think of it in terms of a sale for fair market value and payment of the loan balance); (b) upon other transfer; the foreclosure or abandonment of encumbered property (remember, even gifts of encumbered property to charity where the debt exceeds basis will lead to realization under *Johnson vs Commissioner*; (c) upon transfer of property in payment for services rendered (must recognize gain or loss equal to the difference between fair market value and basis under *International Freighting Corp. vs Commissioner*); and (d) upon transfer of property in connection with dissolution of marriage (reversed by Code Sec. 1041, no realization or recognition).

Code Sec. 1001(c) provides that gains and losses from the sale or exchange of property are recognized "except as otherwise provided in this subtitle." Code Sec. 1017 deals with the discharge of debt (forgiveness income), and Code Sec. 453 deals with installment reporting. The latter is the most helpful.

Where encumbrance exceeds adjusted basis at the time of sale, the seller must confront the need to pay up, particularly because much of the economic benefit was enjoyed earlier by refinancing the property. Payments in the year of sale, therefore, equal the cash received plus the excess of the loan balance over the seller's adjusted basis when the encumbrance is assumed or taken subject to it by the buyer. Thus, in the year of sale, 100% of the first year payments will be taxable, plus the excess of the encumbrance assumed over the seller's adjusted basis (to which the selling expenses are added). (Kirschenmann vs Commissioner (1973, CA9) 488 F2d 270).

So the issue is, does ratable recognition under the open transaction doctrine supercede the recognition rule (above) of Reg § 15A.453-1(b)(3)(i) and *Kirschenmann*?

An examination of the regulation reveals that only those property sales in which the debt is discharged or assumed with no recourse to the seller came under the foregoing recognition rubric. Therefore—especially in light of the case IRS hates the most (Warren Jones Co. vs Commissioner, (1975, CA9) 524 F.2d 788)—we may reasonably infer no rule contrary to that of the open transaction doctrine. Thus, basis is reduced by the excess amount, selling expenses are ignored on exchange of the property for the annuity, leaving annuity installments based on the equity, allocated to capital gain and to (the tax-free recovery of) basis.

(8) If the private annuity agreement is with all of the Annuitant's children (rather than one), the shared payment burden may be easier to bear.

(9) Finally, the Annuitant may exchange only the remainder interest in the property for the life annuity. Use and enjoyment of the property is retained by the Annuitant for life, and the annuity payments are reduced proportionately. That means, of course, that the Payor must fund the annuity payments from personal resources.

As noted above, the obligation to make the annuity payments cannot be secured without risk that the gain on sale must be recognized and the tax paid by the Annuitant at the time of the exchange. (Estate of Bell, (1973) 60 TC 469) "Informal" security, however, may be obtained for one significant risk, i.e., the Payor's premature death. Since the Payor may die before the Annuitant, and since the obligation continues as to the estate of the deceased Payor, and since the

heirs and other creditors of the deceased Payor may not have the Payor's charitable instincts, and since the estate of the deceased Payor may be short of cash to pay taxes and costs of administration, collecting the post-death annuity payments may prove problematical for the Annuitant. Therefore, it may be advisable to insure the life of the Payor with a low-cost term life insurance policy, perhaps decreasing in order to track the decreasing balance on the annuity obligation. The Payor is applicant owner and his or her estate is the named beneficiary. At death, the policy proceeds are included in the Payor's gross estate, offset by the annuity obligation owed to the Annuitant. If the amount involved is large enough to justify the transaction costs, the estate may be left with the obligation as an estate tax deduction while shifting the policy proceeds out of the estate by means of an irrevocable life insurance trust.

Additionally, life insurance can be an ideal medium for equalizing the assets going to different children. For example, if a business is the exchange property, and two daughters are active in it, its value is gone—as is the income stream—on the death of the Annuitant; leaving the non-participating son with no inheritance to that extent. Perhaps that works, since, after all, the daughters bought the business with their promise of a life annuity. But, certainly if it is viewed to some extent as a gift, an adjustment is appropriate. Life insurance with the premiums paid by either the daughters or the Annuitant, is a convenient way to do it in exact denominations.

The following are other practical considerations in evaluating the use of private annuities in estate planning.

In theory, any type of property can be used for the private annuity transaction. The benefits are greatest, however, where the Annuitant either wants to spread the capital gain taxes on appreciated property, or wants to avoid estate taxes. Since the annuity tables required by IRS are based on a fluctuating interest rate fixed on the date of exchange, income producing property generating a return higher than that fixed rate performs best in keeping the Payor's cost manageable. If the return is inadequate or nonexistent, the property must be sold and reinvested. Fortunately, the Payor's new basis in the exchange property facilitates sale by avoiding capital gain taxes.

In order to protect against an IRS claim that the transaction was not made "at arm's length" (i.e., was a product of collusion to improperly reduce taxes), the Annuitant and Payor may consider engaging separate attorneys.

If the Annuitant is concerned about giving the Payor a windfall by dying prematurely (as in the exchange of stock for the annuity with key employees as Payor), an alternate approach (i.e., an installment sale) should be considered.

Private annuity case law deals almost exclusively with single-premium immediate annuities. On specific facts, a single or annual premium deferred annuity may prove attractive, keeping in mind that the absence of supporting case law means that there is less predictability than there is with immediate annuities. For the real estate developer, this may serve as a "family bank" from which to finance future projects.

The Payor may be unimpressed with the idea of buying what he or she expects to

inherit. There are at least two reasons to acquire it by means of a private annuity: (1) it eliminates all doubt (a will can be changed, but the private annuity agreement cannot be modified without the consent of both parties), and (2) liabilities that could consume the property in its present form (e.g., the costs of long-term nursing home care) may be eliminated.

Sometimes, the Payor develops a startling and abiding interest in the longevity of the Annuitant, an interest that could disrupt an otherwise healthy family relationship.

Examine the risks involved. To the Annuitant, the private annuity is an alterative to leaving the property by will. To the Payor, it is an investment, and should be evaluated as such.

If the Annuitant lives beyond life expectancy, the Payor pays more than expected; perhaps much more.

If the Annuitant outlives his life expectancy, the capital gain portion of the annuity installments become ordinary income.

The Payor receives no income tax deduction for the annuity payments. The need to earn a large enough pre-tax investment return to permit the payment of annuity installments without principal invasion may place investment pressure on the Payor leading to unreasonable risks.

The Annuitant must rely on the Payor's unsecured promise to pay.

The Annuitant is at risk that the Payor's creditors will take the property and leave the Payor without the resources from which to make the annuity payments.

The Payor's estate remains liable for the private annuity obligation, even if the Payor predeceases the Annuitant.

Incorrect valuation can lead to unexpected gift or estate taxation.

If the Annuitant lives a long time, inflation will reduce the purchasing power of the annuity payments. Inflation will also make it easier for the Payor to make the payments.

If the Annuitant is up in years, the annuity payments may be unaffordably high.

If the annuity payments are not needed for the Annuitant's living expenses, the accumulation of excess income will increase the estate value, offsetting all or part of an important advantage to the private annuity.

Remedies.
The most effective way to eliminate the core risks listed above is to combine the private annuity with a foreign, non-grantor trust.

(1) It avoids the risk that creditors of the Annuitant will take the annuity income.
(2) It avoids the risk that creditors of the Payor will take the exchange property or its

proceeds.
(3) It avoids basis adjustment on the death of the Payor.
(4) Because the Payor is located in a no-tax jurisdiction, it reduces the temptation to take unwarrranted investment risks; the full return is available to service the annuity obligation. This, in turn, allows a structure by which to preserve the exchange property principal—perhaps to make it grow—leaving the remainder in a trust for future generations.

That discussion, however, is beyond the scope of this article.