Estate Planning Analysis

¶26,121. What is a "private annuity".

Annuities are not limited to commercial contracts issued by life insurance companies. A private annuity typically involves the transfer of property to a transferee (the "obligor") who promises to make periodic payments to the transferor (the "annuitant") for the remaining life of the transferor. Or the obligor may agree to make periodic payments until a specific monetary amount is reached or until the annuitant's death, whichever occurs first (for special rules that apply to such annuities, see ¶26,127). Private annuity arrangements are often used for intra-family transfers, where an older family member transfers appreciated property to a younger family member.

RIA observation:

A private annuity differs from a commercial annuity issued by an insurance company in several respects:

(1) In a private annuity, an individual typically transfers property (often appreciated property), rather than cash, in return for the annuity.
(2) In an unsecured private annuity where a family member, a corporation or business controlled by the family, or an unrelated purchaser, promises to make the annuity payments, the risk that the promisor will be unable to make the payments throughout the annuitant's life is likely to be greater than in the case of a commercial annuity issued by an insurance company, which is subject to governmental supervision and regulation.
(3) The value of the property transferred in a private annuity transaction may not be the same as the value of the annuity received.

RIA observation:

Code Sec. 2702 (the section of the Chapter 14 rules that deals with intra- family transfers of interests in trusts, see et seq.¶47,901 et seq.) presumably does not apply to private annuities. Code Sec. 2702 provides special valuation rules that apply in valuing *an interest in trust retained by a transferor* after the transfer of an interest in trust to a member of the transferor's family. [17] For purposes of Code Sec. 2702 , the transfer of an interest in property with respect to which there are one or more term interests is treated as a transfer of an interest in trust. [18] Although Code Sec. 2702(c)(1) (footnote 18) might seem to suggest that private annuities are subject to the special valuation rules of Code Sec. 2702, this is probably not so, because the annuitant has not *retained an interest* in any specific property; he has instead transferred property to the obligor in exchange for the obligor's unsecured promise to pay him an annuity.

17

Code Sec. 2702(a)(1).

18

Code Sec. 2702(c)(1).

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Estate Planning Analysis

¶42,913. What is a "private annuity."

A "private annuity" typically involves the transfer of property to a transferee who promises to make periodic payments to the transferor for the remaining life of the transferor. Or the transferee may agree to make periodic payments until a specific monetary amount is reached or until the transferor's death, whichever occurs first. Private annuity arrangements are often used for intra- family transfers, where an older family member transfers appreciated property to a younger family member. [4]

Where property is transferred, or a right to property is surrendered, in exchange for payments for life, the transferor usually is treated as if he had bought an annuity. [5]

RIA observation:

A private annuity differs from a commercial annuity issued by an insurance company in several respects:

(1) In a private annuity, an individual typically transfers property (often appreciated property), rather than cash, in return for the annuity.
(2) In an unsecured private annuity where a family member, a corporation or business controlled by the family, or an unrelated purchaser, promises to make the annuity payments, the risk that the promisor will be unable to make the payments throughout the annuitant's life is likely to be greater than in the case of a commercial annuity issued by an insurance company, which is subject to governmental supervision and regulation.
(3) The value of the property transferred in a private annuity transaction may not be the same as the value of the annuity received.

Private arrangements which may be annuity contracts include transfers of property to members of taxpayer's family, or to a corporation or business controlled by the family, or to an unrelated purchaser in return for a life income, see ¶42,914 et seq.

A transfer made to a charity, or an individual *not* a family member, also may be treated as a private annuity. [6] For private annuity treatment of transfers of money or property to schools, hospitals, churches, or other eleemosynary institutions in return for life payments, see ¶42,926 et seq.

Settlement of a will contest or other estate distribution difficulties by acceptance of a life income from the estate, heirs or legatees, or renunciation of a legacy in exchange for life payments also involve private annuity issues, see ¶42,929 et seq.

For the treatment of a transaction where a private annuity isn't secured, see ¶42,914.

For the rules that apply to secured private annuities, see ¶42,918.

For whether a transaction is treated as a private annuity or an installment sale, see ¶42,923.

For situations in which a transaction for lifetime payments is treated as other than the purchase of an annuity, see and¶42,922 and 42,925 .

4

GCM 39503.

5

Ware, Mary v. Com., (1947, CA5) , , , affg (1946) , Ware, Mary v. Com., (1947, CA5) 35 AFTR 809, 159 F2d 542, 47-1 USTC ¶9142, affg (1946) PH TCM ¶46208, 5 CCH TCM 749 ; Steinbach Kresge Co, (1940, DC NJ) , , Steinbach Kresge Co, (1940, DC NJ) 25 AFTR 533, 33 F Supp 897, 40-2 USTC ¶9682; Gillespie, F., (1938) , acq Gillespie, F., (1938) 38 BTA 673, acq ; Steenburg, Edmund, BTA Memo (1941) Steenburg, Edmund, BTA Memo (1941) 43 BTA 1211.

6

Ware, Mary v. Com., (1947, CA5) , , , affg (1946) , Ware, Mary v. Com., (1947, CA5) 35 AFTR 809, 159 F2d 542, 47-1 USTC ¶9142, affg (1946) PH TCM ¶46208, 5 CCH TCM 749 .

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¶ 12.08[5] Private Annuities

A private annuity (also called a family annuity) is similar to a commercial annuity (although not issued by an insurance company) and can accomplish several tax and nontax estate planning objectives. [20] For estate planning, these annuity arrangements are usually made between the preretiree or retiree and his or her children or other relatives. Typically, an individual transfers real estate or other assets to children in exchange for a promise to pay an annuity to the transferor for life. This arrangement effectively removes the asset from the transferor's estate and ensures him or her lifelong income from an asset that previously may well have been illiquid.

Private annuities are complex arrangements that require considerable professional expertise to set up, and they have some disadvantages. If accreted property is transferred, the original owner will incur **capital gains taxes**, although capital gains recognition will be **deferred.** At least part of the annuity income is taxed as ordinary income, [21] and, depending on the circumstances, the transferor may be at risk from default on annuity payments if the relative cannot make the required annuity payments. There is the risk that the IRS will invalidate the annuity agreement if it feels that the arrangement lacks economic validity. There are also certain disadvantages from the transferee's standpoint. Annuity payments are not tax-deductible, [22] and should the transferor outlive the life expectancy tables on which the annuity must be based, the total of the annuity payments may exceed the value of the property.

Private annuities also have many advantages. Estate taxes are saved because the property is removed from the annuitant's estate. The annuitant is freed of investment and management responsibilities when the property is transferred. Capital gains tax, although incurred, may also be **deferred** with the immediate transfer of property. Also, if the present value of the annuity payments equals the property value, there will be no gift tax, and the additional income may also make it possible to develop a gift program to minimize future estate costs. Another advantage of private annuities is that they allow the owner of a closely held business to keep that business in the family, rather than sell the business to an outsider in order to receive a cash flow. This is also a way for a surviving spouse to dispose of marital deduction property and eliminate it from his or her estate.

Depending on the specific circumstances in each case, a portion of a year's annuity payment is excluded from income and received tax-free, and the balance is taxable as either capital gain, ordinary income, or both. If the value of the property exceeds its basis, there will be capital gain recognition so that each year's payment will consist of ordinary income, return to capital not included in income, and capital gain based on the difference between the present value of the annuity and the tax basis of the property transferred divided by the life expectancy of the annuitant.

Example 12-12

At age 65, Joe Smith transferred property with a basis of $30,000 and a FMV of $90,000 to his daughter in exchange for a life annuity of $8,400 per year, or $700 monthly. The present value of the annuity based on 10% for valuing annuities is $59,664.07 ($8,400 × $ 6.7970 × $ 1.0450), where 1.0450 is a monthly adjustment factor. (The figure 6.7970 comes from IRS tables reflecting a 10% rate-of-return factor.) The FMV of the property ($90,000) less the present value of the annuity ($59,664.07) is considered a gift of $30,335.93 from father to daughter. The excess of the present value of the annuity over the basis is $29,664.07, and the expected return is $121,800 ($8,400 × $ 14.5), the annual payment of the annuity multiplied by the life expectancy of Mr. Smith. The exclusion ratio is $30,000 divided by $121,800, which yields 24.63%. Thus, of the $8,400 in payment received each year, $2,068.92 ($8,400 × 24.63%) is excluded. The capital gain is $2,045.80 ($29,664.07 divided by 14.5) and the balance, $4,285.28, is ordinary income. After the $29,664.07 in capital gain has been fully reported, the

24.6% exclusion ratio is still applied to payments received, but the remaining 75.4% of payments is ordinary income.

Private annuities are well worth considering, particularly by older persons with declining incomes who have accumulated nonearning assets that can be transferred to heirs able to make the periodic annuity payments. But an individual should consider several factors when establishing an annuity in order to secure the agreement. First, the property being transferred should be appraised to prevent any valuation disputes with the IRS. Also, to protect himself or herself, the obligor may want to take into account the annuitant's health and life expectancy when determining how, if at all, the annuity should be structured, and the annuitant may want to take insurance on the life of the obligor and bar any additional annuities in the agreement.

Document Title: ¶12.08. Other Family Estate Planning Considerations
Checkpoint Source: Pond / Personal Financial Planning Handbook: With Forms & Checklists

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Estate Planning Analysis

¶85,761. Private annuity arrangements.

A private annuity arrangement ordinarily involves a sale of property in exchange for an annuity for the seller/transferor's life. Under the private annuity rules, there's no gift tax if the sale is made at market price, there's no estate tax on the property remaining after the taxpayer's death, and the taxpayer's taxable gain on the sale is spread over the annuity payments he receives.

However, IRS treated a sale for a private annuity as a grantor trust where the taxpayer "sold" stock to a trust, which he had created a month before for the benefit of a grandchild, in exchange for the trust's contractual obligation to pay him a certain amount annually for the rest of his life. The only funds available for making the annual payments were those received as income from the stock put into the trust, unless the stock was converted into cash. Since all the income of the trust was, or may have had to have been, used to make the payments to the grantor, he was treated as the owner of the trust and taxed on all the income. [42]

RIA observation:

Treating a private annuity arrangement as a grantor trust nullifies all the expected tax benefits because the transaction would result in a gift, in taxable income to the grantor, and would ultimately result in an estate tax at the grantor's death.

The Tax Court has upheld IRS in treating a sale for a private annuity as being in substance a transfer of the property to the trust for the transferor's children, with the transferor/grantor reserving a right to the trust income for life. The court also suggested that the same rule could apply to a sale directly to a member of the family in exchange for his promise to pay the private annuity, where the arrangement was in substance a trust because:

(1) The annuity payments were equal to the income of the trust.
(2) The corpus would be intact for the children.
(3) There were no down payments, interest or security that would be normal for a sale.
(4) The only source of annuity payments here was income from the trust, which is alien to a sales arrangement.
(5) The sales price was less than the market value.
(6) The arrangement provided for no interest on the sales price. Annuities, said the court, include interest. [43]

Similarly, the transfer of stock by taxpayers to trusts created by business associates for the benefit of the taxpayers, in exchange for private annuities from the trusts, wasn't a valid annuity arrangement. While taxpayers weren't the grantors, they were members of an advisory committee which effectively controlled the operations of the trusts. The basic reason for taxing the taxpayers was that the annuity payments were never intended to be and were not annuity payments. The entire transaction was designed to allow taxpayers to maintain control over the property transferred and its proceeds while claiming the benefits of so-called private annuities. [44]

The Ninth Circuit, however, reversing the Tax Court, refused to treat a private annuity arrangement as a grantor trust. It found no indication that the annuity payment in issue was "a mere disguise" for transferring the income of the trust to the taxpayer. Thus, it couldn't disregard the transaction's formal structure. Although the taxpayer had sold the property for less than she would have to a stranger, this didn't make the transaction any less a sale. At most it meant that the transfer was partly a gift. Nor did the informalities in the trust's operation make the taxpayer the owner of the trust rather than its

annuitant- creditor, in view of the fact that she hadn't taken an active role in the trust's management. She was not well-informed concerning trust investments and held no power to manage the trust or control the trustees. The required payments under the annuity arrangement were made annually and did not fluctuate with the trust income. Thus, said the Ninth Circuit, the fundamental annuity obligation had not been ignored or modified.

The Ninth Circuit distinguished *Lazarus* (footnote 43) on the grounds that there, almost immediately after receiving the stock, the *Lazarus* trust sold it for a nonassignable, nonnegotiable note which became its sole asset and produced just enough income to make the required annuity payments. Here there was no such tie-in between the income of the trust and the amount of the annuity. In contrast to *Lazarus,* trust principal here could be used to pay the annuity, and in some years was so used. In years when income exceeded the amount due the taxpayer, the excess was invested in other assets. [45]

The Ninth Circuit also held that a transfer of stock to a trust may not be recharacterized merely because the transaction was part of a prearranged plan to minimize tax liability or because the transferred property formed the bulk of the estate. Informalities in the administration of the trust didn't justify disregarding the formal structure of the transaction as a sale in exchange for an annuity. [46]

The Tax Court distinguished the Ninth Circuit's reasoning in *La Fargue* (footnote 45) by finding that the actual conduct of the taxpayer and the trustee indicated a disregard of the transaction's formal structure. This was demonstrated by evidence including the taxpayer's failure to transfer part of the assets to the trustee, his continued control over the assets and the failure of the trustee to secure title to the property. [47]

Similarly, the Tax Court denied annuity treatment where the taxpayer didn't relinquish control over stock warrants that he had nominally transferred to a foreign trust. [48] And the Tax Court refused to respect a transfer of real estate to a Bahamian corporation in exchange for a private annuity, where no deed was delivered or recorded for the properties, the transferor taxpayers retained control of the properties, collected the rent on their own behalf, received the proceeds from the sales of some of the properties, and received the remaining properties back from the corporation. [48.1]

In a case appealable to the Ninth Circuit involving a trust-annuity arrangement "extremely similar" to *LaFargue* (footnote 45), the Tax Court held that the taxpayer wasn't the owner of any portion of the trust income for purposes of Code Sec. 677 . The Tax Court expressed no opinion as to whether, in cases not appealable to the Ninth Circuit it would follow the decision in *LaFargue* (footnote 45). [49]

42

Rev Rul 68-183, 1968-1 CB 308.

43

Lazarus, Simon, (1972) , acq 1973-2 CB 2, affd (1975, CA9) , , Lazarus, Simon, (1972) 58 TC 854, acq 1973-2 CB 2, affd (1975, CA9) 35 AFTR 2d 75-1191, 513 F2d 824, 75-1 USTC ¶9387.

44

Bixby, Mark, (1972) , acq 1975-2 CB 1, acq 1975-2 CB 2Bixby, Mark, (1972) 58 TC 757, acq 1975-2 CB 1, acq 1975-2 CB 2.

45

LaFargue, Esther v. Com., (1982, CA9) , , , revg & remg on this issue (1979) , on remand (1985) , , LaFargue, Esther v. Com., (1982, CA9) 50 AFTR 2d 82- 5944, 689 F2d 845, 82-2 USTC ¶9622, revg &

remg on this issue (1979) 73 TC 40, on remand (1985) TC Memo 1985-90, PH TCM ¶85090, 49 CCH TCM 839.

46

Stern, Sidney v. Com., (1984, CA9) , , , revg & remg (1981) , on remand (1992) ,, Stern, Sidney v. Com., (1984, CA9) 54 AFTR 2d 84- 6412, 747 F2d 555, 84-2 USTC ¶9949, revg & remg (1981) 77 TC 614, on remand (1992) TC Memo 1992- 374, RIA TC Memo ¶92374, 64 CCH TCM 1.

47

Horstmier, Arthur, (1983) , , Horstmier, Arthur, (1983) TC Memo 1983-409, PH TCM ¶83409, 46 CCH TCM 738.

48

Weigl, Louis, (1985) Weigl, Louis, (1985) 84 TC 1192.

48.1

Spearbeck, Tim, (1995) ,, Spearbeck, Tim, (1995) TC Memo 1995-357, RIA TC Memo ¶95357, 70 CCH TCM 258.

49

Benson, Marion, (1983) Benson, Marion, (1983) 80 TC 789.

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Estate Planning Analysis

¶42,922. Transactions treated as a transfer with a retained life estate.

A purported private annuity transaction may be treated as a transfer with a reserved life estate. [40] Under this view, the transaction is treated as a transfer of the property to a trust for the benefit of the obligors under the "annuity," which gives the grantor (i.e., transferor) a right to receive the trust income over his lifetime. Thus, under the trust rules, the annuitant must include in income the *full* amount of payments received. [41] The property transferred also must be included in the annuitant's gross estate as a transfer with a reserved life estate. [42]

A transfer of property in return for lifetime payments was not treated as a private annuity where a taxpayer set up a trust for his children and sold property to it in exchange for a private annuity for life. This transaction was treated as being in substance a transfer of the property to the trust for the children, with the grantor reserving a right to the trust income for life. This nullified all the expected tax benefits because the transaction resulted in a gift, and in taxable income to the grantor. It also would ultimately have resulted in an estate tax at his death. The Tax Court also suggested that the same rule could apply to a sale directly to a member of the family in exchange for his promise to pay the private annuity, where the arrangement was in substance a trust. The court based its decision on the following:

(1) the annuity payments were equal to the income of the trust;
(2) the corpus would be intact for the children;
(3) there were no normal sale elements, i.e., down payments, interest or security;
(4) the only source of annuity payments here was income from the trust;
(5) the "sales" price was less than the market value; and
(6) unlike with an annuity, the arrangement here did not provide for interest on the sales price.

[43]

In two later cases, however, the Ninth Circuit reversed the Tax Court to hold that transfers were for annuities and not for retained life interests. In the first case, the taxpayer had control over the trustees or the trust's assets but, unlike in *Lazarus* (above), there was no tie-in between the trust income and the annuity payments. [44] In the second case, the court upheld the transaction as a sale even though there were certain "informalities" in the administration of the trust (such as failure to timely notify the stock issuers about the transfer). [45]

Although strict compliance with trust administration rules thus isn't required to characterize a transfer in exchange for payments as a private annuity arrangement, ownership of the property must be transferred to the trust. For example, there was no sale in return for an annuity to a foreign situs trust where the cash involved was paid not to the trust, but to an attorney's escrow account, and the real property purportedly transferred to the trust was still treated by taxpayer as his (he collected rent, paid real estate taxes and conveyed some of the property). Also, deeds to the trust were backdated and not promptly recorded. Taxpayer's attorney maintained a "system" whereby any transfer to a number of interrelated entities was a credit to taxpayer's account, and any "annuity" payment to taxpayer acted to reduce his "balance" in the "system." In this situation, the benefits of ownership continued to inure to taxpayer despite the purported transfers to the trust. [46]

40

Lazarus, Simon, (1975, CA9) , , , affg (1972) , acq (1973) 1973-2 CB 2Lazarus, Simon, (1975, CA9) 35 AFTR 2d 75-1191, 513 F2d 824, 75-1 USTC ¶9387, affg (1972) 58 TC 854, acq (1973) 1973-2 CB 2; Schwartz, Cornelia Est, (1947) , acqSchwartz, Cornelia Est, (1947) 9 TC 229, acq; Bettendorf Co, Joseph v. Com., (1931, CA8) , , Bettendorf Co, Joseph v. Com., (1931, CA8) 9 AFTR 1303, 49 F2d 173, 2 USTC ¶723; Fay, Michael, (1936) Fay, Michael, (1936) 34 BTA 662; Com. v. Kann, Bertha Est, (1949, CA3) , , Com. v. Kann, Bertha Est, (1949, CA3) 37 AFTR 1434, 174 F2d 357, 49-1 USTC ¶9271.

41

Lazarus, Simon v. Com., (1975, CA9) , , , affg (1972) , acq (1973) 1973-2 CB 2Lazarus, Simon v. Com., (1975, CA9) 35 AFTR 2d 75- 1191, 513 F2d 824, 75-1 USTC ¶9387, affg (1972) 58 TC 854, acq (1973) 1973-2 CB 2.

42

Updike, Robert, (1937, CA8) , , , cert den (1937, S Ct) , Updike, Robert, (1937, CA8) 19 AFTR 194, 88 F2d 807, 37-1 USTC ¶9170, cert den (1937, S Ct) 301 US 708, 81 L Ed 1362 ; Schwartz, Cornelia Est, (1947) , acqSchwartz, Cornelia Est, (1947) 9 TC 229, acq.

43

Lazarus, Simon v. Com., (1975, CA9) , , , affg(1972) , acq(1973) 1973-2 CB 2Lazarus, Simon v. Com., (1975, CA9) 35 AFTR 2d 75- 1191, 513 F2d 824, 75-1 USTC ¶9387, affg(1972) 58 TC 854, acq(1973) 1973-2 CB 2.

44

LaFargue, Esther v. Com., (1982, CA9) , , , revg on this issue (1979) , on remand(1985) , , , affd (1986, CA9) , , LaFargue, Esther v. Com., (1982, CA9) 50 AFTR 2d 82- 5944, 689 F2d 845, 82-2 USTC ¶9622, revg on this issue (1979) 73 TC 40, on remand(1985) TC Memo 1985- 90, PH TCM ¶85090, 49 CCH TCM 839, affd(1986, CA9) 58 AFTR 2d 86-5859, 800 F2d 936, 86-2 USTC ¶9715.

45

Stern, Sidney, (1981) , later proceeding(1983, DC NV) , , , later proceeding(1984, CA9) , , , later proceeding (1986, DC NV) , , , on remand(1992) ,, Stern, Sidney, (1981) 77 TC 614, later proceeding (1983, DC NV) 53 AFTR 2d 84-703, 563 F Supp 484, 84-1 USTC ¶9478, later proceeding(1984, CA9) 54 AFTR 2d 84-6412, 747 F2d 555, 84-2 USTC ¶9949, later proceeding (1986, DC NV) 59 AFTR 2d 87-352, 650 F Supp 16, 86-2 USTC ¶9795, on remand(1992) TC Memo 1992-374, RIA TC Memo ¶92374, 64 CCH TCM 1.

46

Horstmier, Arthur, (1983) , , Horstmier, Arthur, (1983) TC Memo 1983-409, PH TCM ¶83409, 46 CCH TCM 738.

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¶ 23.01 Introduction

A private annuity is a transaction in which one individual sells another individual [1] an item of property in exchange for an annuity, often measured by the seller's lifetime.

The annuity must be unsecured to avoid immediate taxation of gain arising from the sale. [2] The seller can retain no interest in the transferred property, nor should payment of the annuity be tied to income from the property. [3]

Additionally, whether the sale is to an individual or a trust, the annuity should be payable with full recourse to the obligor's independent assets. If the annuity is only payable out of the transferred property, there is too much danger that the annuity will be recharacterized as an interest in the transferred property. Thus, the purchaser should be liable for payment of the annuity even if the transferred property is exhausted in paying the annuity, and he should be in a financial position to be able to pay the annuity. [4]

The following global example will be used throughout this chapter to explain the effects of a private annuity.

Mom sells Blackacre to Son in exchange for Son's promise to pay her $100,000 per year for her remaining life. At the time of the sale, Mom is 51 years old, and the 7520 rate [5] is 8.2 percent.

¶ 23.01[1] Overview of Transfer Tax Consequences

If the value of Son's promise (according to the tables issued under Section 7520) equals the value of Blackacre, Mom does not make a gift. When Mom dies, nothing is included in her estate.

Example

According to the tables, the actuarial value of Mom's annuity is $1,015,520. If the fair market value of Blackacre is $1,015,520, Mom should not be deemed to have made a gift and Blackacre should not be included in Mom's estate.

¶ 23.01[2] Benefits

The actuarial tables [6] are key in deciding whether to use a private annuity. When are private annuities likely to be a good deal? Primarily, in the following circumstances—

When assets perform better than 7520 rate. If the transferred asset is expected to outperform the 7520 rate at the date of the sale, a private annuity will be expected to be a successful estate freeze.

Example

Blackacre's value is increasing by 10 percent each year. If Blackacre is worth $1,015,520 at the time the private annuity transaction is entered into, and Mom lives for 5 years, she will have excluded property worth $1,635,505 from her estate at the cost of including $589,004 in her estate (assuming Mom reinvested each of her $100,000 annuity payments and earned the 7520 rate (8.2 percent)).

When the annuitant has a shorter life expectancy than indicated in the actuarial tables. The other situation that calls for consideration of a private annuity is one in which a person is not expected to live for his full life expectancy, but whose life expectancy may still be valued under the actuarial tables. [7]

A determination of whether Mom has made a gift on the initial sale will depend partly on her life expectancy at the time. For instance, suppose, in the Global Example, that Blackacre is worth $4,062,080 and Mom sells it to Son in exchange for an annuity of $400,000/year for Mom's life. Mom's life expectancy according to the tables is thirty-two and two-tenths years, but she has an advanced case of diabetes and is actually expected to live for five years. Mom is still eligible to use the tables. However, the probability is that only five payments will be made. If, in fact, Mom dies after receiving only five payments, Mom will have made a transfer-tax-free transfer of $2,062,080 ($4,062,080 less $2,000,000)—a stunning estate planning result.

Property is not required to transact a private annuity—an annuity can be purchased for cash. Hence, Mom could transfer cash in exchange for an annuity, feeling pretty sure she would only receive five payments.

There does reach a point at which an unhealthy seller cannot use the actuarial tables. According to the regulations, the actuarial tables cannot be used if there is at least a 50 percent chance that the taxpayer will die within a year, due to his affliction with a terminal illness or condition. [8] Hence, the private annuity is not a deathbed technique. Rather, it should be considered in situations in which the seller's life expectancy is shorter than normal, but more than one year.

When the annuitant needs income. A third situation could exist if, for personal financial reasons, the seller cannot surrender the property sold without receiving an income. In such a situation, the private annuity would need to be compared to similar techniques that can provide an income stream to the seller.

1

A private annuity can also be transacted with an entity. Such a transaction is subject to special rules and is discussed at ¶ 23.07 below. An annuity can also be paid in reurn for cash.

2

If the annuity payments are secured, the transaction will be treated as a commercial annuity, subject to immediate tax on the gain on the property sold. Bell v. Comm'r, 60 TC 469 (1973) .

3

IRC § 2036; see also Ray v. United States, 762 F2d 1361 (9th Cir. 1985) ; Lazarus v. Comm'r, 513 F2d 824 (9th Cir. 1975), aff'g 58 TC 854 (1972), acq., 1973-2 CB 2 .

4

Estate of Mitchell v. Comm'r, 1982 PH TC Memo 82,185, 43 TCM (CCH) 1034 (1982) .

5

The "7520 rate" is 120 percent of the applicable federal midterm rate, rounded to the nearest 2/10 of one percent. IRC § 7520. The 7520 rate and its ramifications are discussed more fully in Chapter 11 .

6

The tables are found in Publications 1457 (Book Aleph) and 1458 (Book Beth). These tables were published in July 1999, reflecting revisions made to incorporate mortality data obtained from the 1990 Census.

7

See Chapter 11 for a discussion of when the tables cannot be used due to a person's poor health. This chapter assumes that the tables can be used unless specifically noted otherwise.

8

Treas. Reg. §§ 20.7520-3(b)(i), 25.7520-3(b)(3). See Chapter 11 on the actuarial tables for an extensive discussion.

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Estate Planning Analysis

¶42,912. Taxation of payments under private annuities.

Gross income includes any amount received as an annuity under an annuity, endowment, or life insurance contract. [1] Any contract that is considered to be a life insurance, endowment, or annuity contract "in accordance with customary practice of life insurance companies" is taxed under Code Sec. 72 as an annuity contract. It is immaterial whether the contract is entered into with an insurance company. [2]

The transfer of property in exchange for a "private annuity" (see ¶42,913) is not a taxable transaction, see ¶42,917 (although it may be if the amount of the annuity payments have a determinable value, see ¶42,918 et seq.).

RIA observation:

Thus, a taxpayer who exchanges appreciated property for a private annuity can defer the gain that would have been taxed had he either sold the property, or exchanged it for a commercial annuity.

The tax treatment of payments under a private annuity contract corresponds to that of a commercial contract. [3] Thus, for the taxation of amounts received "as an annuity," see ¶42,801 et seq. For the taxation of distributions not received as an annuity, see ¶42,754 et seq.

Where a taxpayer transfers appreciated property to a member of the taxpayer's family, a corporation or business controlled by the family, or to an unrelated purchaser in return for a lifetime annuity, the total amount *transferred* may be a combination of:

(1) a gift, see ¶42,914, and
(2) value given in return for the annuity, see ¶42,914 ,

while the total amount *received* by the transferor may consist of:

(3) gain on the transfer of the property (i.e., to the extent the value of the annuity payments to be received, exceeds the transferor's basis in the property transferred), see ¶42,917, and
(4) annuity income and a return of basis in the annuity, see ¶42,914.

RIA illustration:

T transfers property with a fair market value of $300,000 to a corporation owned by T's family, in return for annuity payments for the remainder of T's life. T's basis in the property transferred is $100,000. The present value of the annuity payments to T is $200,000. The taxation of T's private annuity involves the following issues: (1) the *timing* of T's gain regarding the property ($300,000 – $100,000); (2) the portion of the $300,000 (if any) that is a gift; and (3) the amount of T's *investment* in the annuity contract (i.e., whether the investment in the contract is: (a) the $300,000 given for the annuity, (b) the $200,000 fair market value of what was given for the annuity, or (c) the $100,000 of T's basis in the property given for the annuity).

For the timing of the recognition of gain on property given in return for an *unsecured* annuity, see ¶42,917. For the timing of gain recognition where the private annuity is *secured,* see ¶42,918 .

For the treatment of transfers of property to a charity (or other exempt organization) in exchange for a private annuity, see ¶42,926.

1

Code Sec. 72(a).

2

Reg § 1.72-2(a)(1)Reg § 1.72-2(a)(1).

3

Code Sec. 72(a).

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Estate Planning Analysis

¶42,915. Determining the investment in the contract for a private annuity.

IRS has said that, in a private annuity transaction involving a transfer of appreciated property for an unsecured life annuity promise, the annuitant's investment in the contract for determining the exclusion ratio is his *basis in the property transferred.* [11]

Illustration:

V transfers property with a fair market value of $60,000 to her child, in return for an annuity for the remainder of V's life. V's basis in the property transferred is $20,000. (Assume that the present value of the annuity is greater than $20,000.) In determining the exclusion ratio to find the excludable portion of each payment V receives, under IRS's approach, V's investment in the contract is $20,000. [12]

Unlike IRS, the Tax Court has indicated that, in a private annuity transaction, the annuitant's investment in the contract for determining the exclusion ratio is the *fair market value of the property transferred*— rather than his basis in the property transferred. [13]

RIA observation:

Under the Tax Court's approach, although the exclusion ratio may be larger, since the fair market value of the property transferred is used as the investment in the contract, the transferor of the property would have a *gain:* the amount realized less the transferor's basis in the property transferred.

For when the gain on the transfer of property in exchange for an *unsecured* annuity is includible in the transferor's income, see ¶42,917.

For taxation of the gain on the transfer of property in exchange for a *secured* annuity, see ¶42,918 .

RIA illustration:

V transfers property with a fair market value of $60,000 to her child, in return for an annuity for the remainder of V's life. V's basis in the property transferred is $20,000. (Assume that the present value of the annuity is greater than $20,000.) In determining the exclusion ratio to find the excludable portion of each payment V receives, under the Tax Court's approach, V's investment in the contract is $60,000. V also has a gain on the transfer in the amount of $40,000 ($60,000 − $20,000).

Where private annuity payments are *secured* (see ¶42,918), the Tax Court has held that the investment in the contract is the fair market value of the property transferred for the annuity (or the present value of the annuity, if less, and the transaction was not at arm's length, see below). Taxpayers' basis in stock transferred for an annuity was $21,000, and its value on the date of transfer was $208,000. The present value of the annuity was $126,000 (as measured by the IRS gift and estate tax valuation tables). IRS argued that the taxpayers' investment in the annuity which they could recover tax-free was only $21,000, the cost basis of the stock transferred under the rules of Rev Rul 69-74 (¶42,914) for private annuities. Taxpayers argued that their investment in the contract was the

market value of their stock (under the rules of Rev Rul 239, ¶42,921 , which applied under the '39 Code). The Tax Court found that because both Rev Rul 69-74 and Rev Rul 239 involved *unsecured* private annuities neither applied. Instead, the investment in the contract was $126,000. [14]

RIA observation:

Although the Tax Court used the fair market value of the property transferred as the investment in the contract in cases that involved *secured* private annuities (i.e., *Bell* and*212 Corp*, see ¶42,918), it indicated in *212 Corp* that this was its approach regardless of whether the private annuity was secured. It would seem that whether an annuity is secured should not determine the investment in the contract.

RIA observation:

IRS's use of basis rather than the fair market value of the property transferred to determine "cost" reflects the "gift" aspect of these transfers.

For determining the investment in the contract where property is exchanged at least in part as a gift, and partly for a private annuity, see ¶42,916 .

11

Rev Rul 69-74, 1969-1 CB 43.

12

Rev Rul 69-74, 1969-1 CB 43.

13

212 Corp, (1978) 212 Corp, (1978) 70 TC 788.

14

Bell, Lloyd Est, (1973) Bell, Lloyd Est, (1973) 60 TC 469.

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Tax Planning & Practice Guides

¶602. Strategies hurt by rising rates

Higher interest rates produce less favorable results for individuals engaging in the following strategies.

Private annuity. A private annuity offers a number of income, gift and estate tax advantages. It also can save estate administration expenses and offer other nontax advantages as well. In the typical private annuity transaction, a parent transfers property to his child in return for that child's unsecured promise to pay the parent a fixed, periodic income for life. If the fair market value of the property transferred equals the present value of the annuity under the Code Sec. 7520 valuation tables, there is no gift tax due. An increase in the interest rate increases the annual payment amount that the younger family member has to make to the older family member to prevent a gift from arising on the transfer.

> **RIA observation:** Even though the higher interest rate results in a higher annual payment to the senior family member, that member often will prefer a lower rate so as to be able to transfer more property at the lowest possible cost to the younger family member.

> **RIA illustration:** At a time when the Code Sec. 7520 interest rate is 6.2%, Clark, age 70, transfers property worth $1 million to his daughter in exchange for a private annuity. Clark's daughter must make an annual payment of $119,323 to prevent a gift from arising on the transfer. This figure is determined by dividing $1 million by the annuity factor from table S of IRS Publication 1457, "Actuarial Values, Book Aleph" for a 70-year old and an interest rate of 6.2% (if the pub is unavailable, the annuity factor can be computed from the remainder factor in the regs, see ¶ 303).

> **RIA illustration:** In July 2000, Stafford, age 70, transfers property worth $1 million to his son in exchange for a private annuity. Stafford's son must make an annual payment of $134,544 to prevent a gift—significantly higher than the payment that Clark's daughter must make. The higher payment results from the rise in the Code Sec. 7520 interest rate to 8% for July 2000.

References: FTC 2d/FIN ¶ J-5250 ; United States Tax Reporter ¶ 724.05 ; TaxDesk ¶ 14,748 .

Grantor retained annuity trust (GRAT). An individual can save transfer tax by setting up a GRAT. The individual retains an annuity interest for a specified term at the expiration of which the property goes to a child or other individual named at the outset. Gift tax is payable but only on the present value of the remainder interest, which is the value of the property transferred to the trust less the value of the retained annuity interest. A higher interest rate decreases the value of the annuity retained by the grantor and thus increases the value of the gift of the remainder in a GRAT.

> **RIA illustration:** At a time when the Code Sec. 7520 interest rate is 6.2%, Green transfers $1 million to a trust. The trust is to pay him an annual annuity of $80,000 for 10 years. At the end of the 10 years, the property is to go to his daughter. The value of Green's retained annuity is $583,264. This figure is determined by multiplying $80,000 by 7.2908, which is the annuity factor from table B of IRS Publication 1457, "Actuarial Values, Book Aleph" for a 10-year term and an interest rate of 6.2% (if the pub is unavailable, the annuity factor can be computed from the remainder factor in the regs, see ¶ 303). The value of the gift of the remainder to Green's daughter is $416,736.

RIA illustration: In July 2000, Black engages in transaction that's similar to Green's in *Illustration(3)*. The value of Black's retained annuity is $536,808 and the value of the gift is $463,192.

References: FTC 2d/FIN ¶ P-6650 ; TaxDesk ¶ 72,122 .

Charitable lead annuity trust. An increase in the interest rate decreases the gift or estate tax deduction for the annuity interest going to the charity and increases the value of the gift of the remainder interest going to a private beneficiary. See ¶ 506 for discussion of charitable lead trusts.

Charitable transfer of remainder interest in residence or farm. An increase in the interest rate decreases income, estate and gift tax deductions for a remainder interest in a residence or farm (see ¶ 505).

RIA observation: Taxpayers have some flexibility to deal with changing rates in connection with charitable transfers by virtue of the rule allowing a taxpayer to use the Code Sec. 7520 rate for the month of the transfer or for either of the two preceding months. See ¶ 202 .

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INSURANCE TRENDS AND TOPICS

Annuities and Estate Planning

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As we noted in our last column, there has been a very noticeable increase in clients' interest in and questions about the taxation of annuities (see 29 ETPL 308 (June 2002)). In that column, James Ivers addressed some of the key income tax issues. This month, we've asked another expert on the topic, Darlene K. Chandler, J.D., CLU, ChFC, the Director of Advanced Markets Administration Support at Farm Bureau Financial Services in West Des Moines, Iowa, and author of *The Annuity Handbook,* to share comments on the seldom discussed estate planning aspects of annuities. You'll find Darlene's comments extremely helpful in your practice.

The numbers

According to a survey done for the Committee of Annuity Insurers, the average age at which an annuity owner purchases his or her first annuity is age 50. Currently, the average age of all annuity owners is 65. Both of these statistics point toward the fact that most of us plan to use annuities to (1) save for our retirement and (2) pay out during that time. With this in mind, let's look at six issues estate planners should consider in planning for clients who already own or who are contemplating purchasing annuities.

Estate tax treatment of annuities

If you are engaged in estate planning, it is important to know how an annuity is treated for estate tax purposes. What happens, from an estate tax perspective, when the annuitant dies? Generally, if a person dies before the annuity payout period has begun and if the annuity death benefit is payable to the annuitant's estate, the value of the death benefit must be included in the gross estate for federal estate tax purposes under Code Section 2033.

If the annuity death benefit is payable to a named beneficiary, as would more usually be the case, the value of the death benefit is includable in the gross estate under Section 2039. But even if there is no living named beneficiary, if the annuitant/contract owner dies before annuity benefit payments commence, the value of the annuity will be included in the annuitant/contract owner's gross estate. This result assumes that the decedent provided the full purchase price of the annuity. If the decedent provided only a portion of the purchase price, then only a proportional share of the annuity's value

would be included in his or her gross estate for estate tax purposes.

If the value of a nonqualified annuity is not one of the larger items in an individual's total net worth, the fact that the annuity's value must be included in the gross estate may not be a huge concern. But annuities are often held for many years—even decades—and the interest paid by the insurer on the annuity accumulates on an income-tax-deferred basis. So the annuity may have a considerable estate tax value. Therefore, ownership of such an annuity (or annuities) should not be overlooked during the estate planning process or in computing hypothetical probate liquidity needs.

Impact of benefit payout option

If the annuity's payout period has already begun at the time of the annuitant's death, the estate tax inclusion results may differ. The outcome of the estate tax inclusion question depends on the type of benefit payout option that was selected. If the annuity was paying benefits under what is commonly referred to as a "life only" option, contractually, payments end at the annuitant's death. The "life only" payout option pays a benefit from the annuity only during the annuitant's lifetime. Upon the annuitant's death, the issuing insurance company has no further obligation to make payments. Because no further payments will be made, the annuity has no future value and nothing need be included in the annuitant's gross estate.

If, however, some other type of benefit payout option was selected, the annuity will have some value beyond the annuitant's death. For example, suppose that a "life and ten-year certain" payout option was chosen. Under this type of settlement option, the insurance company agrees to pay a certain amount of benefit for the lesser of (1) the annuitant's life or (2) ten years. If the annuitant lives for at least ten years beyond the time that benefit payments commence, the insurer will have no further obligation under the annuity contract upon the annuitant's death. So nothing will be includable in the annuitant's estate from that point on. On the other hand, if the annuitant dies after receiving only four years of annuity payments, the insurance company will be obligated to continue paying the annuity benefit to the beneficiary named in the contract for an additional six years.

If benefits that remain to be paid after the annuitant's death are payable to the decedent's estate, the value of these remaining payments must be included in the gross estate under Section 2033. If, as is more likely, the remaining payments are to be made to a named beneficiary, the value of these payments is includable in the gross estate under Section 2039, assuming the decedent provided the full purchase price of the annuity. The value of this annuity stream, for estate tax purposes, is generally the commuted value of the remaining payments.

Impact of gift of annuity

Now that we have reviewed the estate tax inclusion of nonqualified annuity proceeds or benefit payouts, let's analyze what happens when a gift of an annuity contract is made. The income tax consequences of making a gift of an annuity may not usually be considered as part of the estate planning process, although it is true that re-positioning assets often is involved in establishing, or even maintaining, an effective estate plan. And, of course, making a gift of an asset may be viewed as part of the re-positioning phase of estate planning.

With regard to the consequences of making a gift of an nonqualified annuity, there is a 4/22/87 cut-off date that is important to consider. This date pertains to when the annuity contract was issued rather than when it was transferred or, as is sometimes the case, the date when contributions were made. If a gift of an annuity contract issued *after* this date is made, the annuitant/donor may realize an income taxable gain in the year the gift is made. This gain is equal to the excess of the cash surrender value of the contract at the time of the transfer over the investment in the contract at that time.

Thus, astoundingly, to the great surprise of many clients—and their advisors—a *gift* of an annuity contract issued after the 1987 date may cause a current *income tax* consequence. If, in the course of

planning an estate with an eye toward minimizing estate taxes, transfer of the ownership of an annuity contract seems attractive, it is important to remember this often unintended, and certainly not obvious, income tax result.

Interestingly, if a gift of an annuity contract issued *prior* to the 1987 date is made, an even more unusual income tax consequence may occur. In this instance, if the annuity contract's cash surrender value at the time of the gift is greater than the donor's cost basis and if the person who received the annuity contract as a gift decides to surrender the annuity, the *donor* must report as taxable income the gain that existed at the time the gift was made. In other words, the person who made the gift must report the gain in the contract at the time of the gift but not until the year in which the person who received the gift surrenders the contract.

This is a very dangerous tax trap, particularly since the donor may not even know if or when the donee cashes in the annuity. Years may go by before the donor becomes aware of a personal income tax liability triggered by the action of someone else. Worse yet, the event that triggers the need to pay tax does not create any cash for the donor to pay that tax.

Basis considerations

Generally, another factor that may influence estate planning decisions and recommendations is the basis of an asset. After the 2001 Tax Act, [1] looking at an asset's basis has become more important than before because of the possible repeal of the step-up-in-basis-at-death provision and the newly-created basis allocation choices that may have to be made by the estate administrator in some future year. Of course, what decisions may have to be made regarding the basis of estate assets may be affected by several items, including whether Congress takes action regarding the repeal of the estate tax, the year of the decedent's death, and whether the sunset provision of the 2001 Tax Act ever takes effect. [2]

Typically, the basis of a nonqualified annuity equals the premiums that have been paid into the annuity less any distributions that have been received and excluded from income during the life of the annuity contract. However, there is a limited exception to this rule that applies only to certain variable annuities. If the owner of a variable annuity contract that was purchased prior to 10/21/79 dies before the benefit payout period begins, the variable annuity contract takes a new cost basis. The beneficiary of the variable annuity contract will have, as a basis in the contract, a stepped-up basis. In other words, the beneficiary's basis in the variable annuity contract will equal the value of the contract on the decedent's date of death.

This result is in contrast to the general rule that the beneficiary of an annuity "carries over" the decedent's basis in the contract. Then, under the general rule, it is this carried-over basis that is used in calculating the exclusion ratio to be applied to the annuity payments to determine how much is—or is not—currently subject to income taxation.

IRA and qualified plan annuities

Up to this point, we have been talking only about nonqualified annuity contracts—that is, those annuity contracts that are not issued as part of any qualified retirement plan. Just for this portion of the discussion, let's look at some new final Regulations that do not apply to nonqualified annuities but rather affect Individual Retirement Annuities as well as most types of qualified retirement plans. These Regulations were issued under Section 401(a)(9) and deal with the calculation of minimum required distributions.

The minimum required distribution, or MRD, rules require that IRA holders and participants in most qualified retirement plans begin receiving at least a minimum amount from the IRA or plan at about age 70-1/2. The MRD rules have been known, for a number of years, as among the more complicated and difficult to work with. However, early in 2001, the IRS issued new Proposed Regulations, and in

April 2002, published final Regulations. [3] These new final Regulations have accomplished two things. First, the MRD rules under the Regs. are actually simpler to work with. [4]

Further, and, perhaps more important from an estate planning point of view, the final Regulations have resulted in lower minimum amounts. Accordingly, if an individual is withdrawing only the minimum amount from an IRA or qualified plan each year, the new rules will create a greater likelihood that a portion of the balance in the IRA or plan will pass to his or her beneficiary. It is more likely that a balance will remain in the plan upon the plan participant's death because the minimum amount that was required to be taken out each year is now less than it was before the new Regulations. Obviously, the impact of these new lower minimum required distribution amounts will increase as time goes on and more years pass with the lower amounts in effect.

It is therefore important to make sure that the beneficiary designations are arranged so that, not only will funds in the IRA or plan at the holder's death go where the holder desires, but also that the beneficiary designations are arranged to minimize taxation. A discussion of exactly what steps are involved in this process is beyond the scope of this commentary. However, since the new Regulations were issued, there have been a number of articles written which describe the necessary considerations. [5]

The private annuity

A private annuity is a type of annuity that is neither nonqualified nor part of a qualified retirement plan. Generally, a private annuity is an agreement entered into between two parties, neither of whom issues annuity contracts on a regular basis. (The annuity contracts, both qualified and nonqualified, that are issued by some type of entity—usually an insurance company—are sometimes referred to as "commercial" annuities.)

By entering into a private annuity, typically, one party agrees to pay the other party a sum for life. Generally, the party who will receive this annuity agrees to transfer property or some right to property to the individual who will be making the annuity payments. Hence, this is a sale in which property is exchanged in return for a promise. For example, a son might agree to pay his mother an annuity of a certain amount each month for the remainder of her life in return for an interest in an apartment building she owns.

The computations of the appropriate annuity payment and the income tax implications of the sale are calculations easily performed on a computer. [6] For estate tax purposes, it is useful to know that there is no value left in the private annuity at the annuitant's death (assuming a single life annuitant). Therefore, once the mother in the above example has died, her son would have no further obligation to make annuity payments. Consequently, much like the "life only" annuity settlement option discussed earlier, a private annuity results in no estate tax inclusion in the seller's gross estate. This makes it possible to remove very large amounts of property from a client's estate and works particularly well if a client's health is below average but the client is likely to live for longer than (a rule of thumb) two years. [7]

Darlene K. Chandler, J.D., CLU, ChFC, a former editor of National Underwriter's *Tax Facts*, is currently the Director of Advanced Markets Administration Support at Farm Bureau Financial Services in West Des Moines, Iowa. She is also the author of *The Annuity Handbook: A Guide to Nonqualified Annuities* published by the National Underwriter Company and available by calling 1-800-543-0874.

1

Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16 (6/7/01).

2

For an excellent discussion of basis issues under the 2001 Tax Act, see Kelley, "Basics of Carry-Over Basis," at http://www.leimbergservices.com. It's listed under the Estate Planning Newsletter tab as Commentary 384. See also the following very comprehensive article: Berall, Harrison, Blattmachr, and Detzel, "Planning for Carryover Basis That Can Be/ Should Be/ Must Be Done Now," 29 ETPL 99 (Mar. 2002).

3

See TD 8987 (4/16/02).

4

An MRD Calculator is available by calling 610-924-0515.

5

See *Tools and Techniques of Employee Benefit and Retirement Planning* (800-543-0874). An extensive commentary on this topic, "MRD Final Regulations Annotated," written by Attorney Noel C. Ice, and commentary by CPAs Robert S. Keebler and Barry Picker can be found at http://www.leimbergservices.com.

6

Private annuity computations can be performed on NumberCruncher Software (610-924-0515).

7

See *Tools and Techniques of Estate Planning* (800-543-0874) and *The Cutting Edge* (610-924-0515) for a detailed explanation of private annuities.

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