Private Annuity – Benefits Now Limited

By Hon. C. Raymond Radigan and Adam J. Gottlieb, Esq.

Estate planners often deal with clients who wish to take care of family members and provide for an alternative to an outright gift and to freeze assets so that future appreciation will not be subject to gift, estate and generation-skipping transfer taxes. Annuities are often created to keep appreciated assets out of one's estate, to be relieved of the financial management of assets such as real property, an interest in a closely-held corporation, or other like assets, and to obtain possible income tax advantages.

RISKS

If the amount to be paid to the annuitant is calculated on the yield of the property transferred, or if the annuity is secured, the Internal Revenue Service will undoubtedly take the position that the annuitant retained a prohibited interest in the property transferred and therefore his estate will be subjected to Section 2036 of the Internal Revenue Code, requiring the asset to be included in the decedent's estate for estate tax purposes. Accordingly, a private annuity must be structured to avoid such pitfalls. Before we explore the benefits of a private annuity, we must set forth the disadvantages of the annuity which are:

1. There will be a loss of the potential for a stepped-up basis in the transferred property in the event that the transferred property appreciates in value after the transfer;

2. The transferee's basis in the property is uncertain and he or she may not take an income tax deduction for the payments made to the annuitant;

3. The annuitant takes the risk as to whether the payments will be made by the obligor and that the obligor will have the resources to make the payments, though the obligor must have the ability to meet his annuity obligation;

4. If the annuitant does not exhaust the payments received from the obligor, the residual of those payments will be included in the annuitant's estate for estate tax purposes; and

5. There is a risk that the IRS, because of the facts presented, will contend that the transaction involved a retention of an interest by the annuitant causing the assets to be included in his estate for estate tax purposes under Section 2036 of the Code. IRS may take the position that the entire transaction was a facade since the transactions really involved the transfer of assets with a retained life estate in the assets.

TAX CONSEQUENCES

In planning a private annuity, the practitioner has to take into consideration income and estate tax consequences.

As to income tax consequences, practitioners were heretofore guided by Rev. Rul. 69-74 concerning the division of the annuitant's annuity payments. If an annuity was secured, there could be no stretching of capital gain over the period of the annuity. Conversely, if the payments were unsecured, the payments would be broken down and a portion would be attributed to a return of principal, capital gain and ordinary income.

Under the revenue ruling, a parent transferred appreciated property to his son in exchange for an annuity from the son. The annuity provided for monthly payments of $600, the present value of which was $47,713, pursuant to IRS tables. The parent's basis of the assets was $20,000 and the fair market value of the property transferred by parent was $60,000. Utilizing the Section 7520 rate and the parent's life expectancy at the time, the sum of all payments expected to be paid to parent was $72,720. Since the present value of the annuity payments was $47,713, the excess of the fair market value of the property transferred, $60,000 over the $47,713 is a $12,287 gift from parent to son. The exchange caused a capital gain for the parent of $27,713, the $47,713 less the parent's basis of $20,000 in the transferred property. The basis of $20,000 is an excluded amount, also called a return of principal.

Further, the rules regarding annuities were not so clear before Rev. Rul. 69-

74 with regard to when a capital gain must be recognized. The IRS pressed for gain recognition in the same manner as an installment sale. When payments were received, the exclusion ratio was used to compute the return of principal, and the excess of the present value of the annuity payments over the basis equaled the gain. Many taxpayers took a different position that, because of the uncertainty of the life expectancy of the parent, and the attendant unpredictability of the number of years the parent would continue to receive payments under the annuity, the first payments received by the parent were excluded as return of principal until the basis in the transferred property was returned to parent in full. The payments in excess of the basis would constitute gain. This tax-deferral recognition approach was called the open transaction method. It was based on the notion that no one knew when the payments would cease and that this uncertainty prevented the IRS or anyone else from computing the sum of all payments the parent expected to receive, and thus the exclusion ratio could not be computed. In the revenue ruling, the IRS declared that, unless the annuity fit some limited exceptions, the taxpayer must compute the exclusion ratio and recognize gain when each payment was received, beginning with the very first payment, rather than postponing the recognition to some date in the future when a contingency may or may not occur. The exclusion ratio was computed using the Section 7520.
However, under the facts in the ruling, $20,000 divided by $72,720 (the sum of all expected payments) equals the exclusion ratio of 27.5%. Though Rev. Rul. 69-74 was based on a reaction to the unsuccessful IRS attack on the open transaction doctrine, the open transaction doctrine became no longer applicable in most cases to postpone or eliminate income tax.

As to estate tax considerations, the taxpayer can successfully exclude the private annuity asset with its appreciation from the estate of the annuitant unless the IRS can prove that the transaction was in reality a retained income interest by the annuitant thereby falling under Section 2036 of the Code.

With private annuities, a parent typically transfers property other than cash, usually a business interest to a lower generation family member, in return for an unsecured contractual obligation to pay to the parent a fixed periodic sum for the parent's life. To avoid gift tax, the present value of the annuity payments must equal the value of the property transferred utilizing the rates

found in Section 7520 of the Code. Unless the agreement brings Section 2036 into play, the asset will not be included in the annuitant's estate since the annuity terminates at the parent's death.

NEW PROPOSED REGULATIONS

The Treasury and IRS on October 18, 2006 promulgated Prop. Reg. 141901-05 effective after that date, generally covering private annuities established thereafter that eliminate the deferral of capital gain on private annuity exchanges. The proposed regulations would require the annuitant to recognize gain in the year of the exchange. Thus, the old benefit of private annuities that permitted the annuitant to recognize the gain over the period of the payments would no longer be available under the proposed regulations. While the precise underpinning for this alleged justification is not specifically set forth by the IRS, the potential for abuse occurs often with a parent who can demonstrate that the Section 7520 rates should apply to compute the exclusion ratio and thus the taxable gain but has a shortened life expectancy. The life expectancy is reduced by some personal risk factor but it is still long enough to qualify for Section 7520. It is worthy to note that the new regulations do not apply to charitable annuities.

Since the proposed regulations will require full payment of capital gains tax due at the time of transfer under the new regs, one must determine whether the other benefits attributable to private annuities would warrant their under-taking in an estate plan seeking to have future appreciation avoid gift and estate tax by having assets transferred to a younger generation who would benefit in the future growth of the family asset that would not be diminished, since they would no longer be in the estate of the annuitant.

PLANNING

When contemplating the transfer of property by a parent to a child in exchange for a promise to pay a stream of payments, several options are still available. First, careful drafting of a private annuity can still be of limited use. Since the gain under the proposed regulations must be recognized in the year of the exchange, then it follows logically that if a parent wants to use an annuity, then the parent will seek to reduce the gain. This can be accomplished by reducing the value of the annuity received in exchange for

the property transferred. This benefit is available at the likely cost of an increased gift, since the fair market value of the property transferred and the parent's basis remain the same in all cases. One way to reduce the value of the annuity is to include a nonassignability clause in the agreement.

Second, when the parent is elderly at the time of the exchange, his age would affect the present value of the annuity payments. The older the parent, the less valuable the annuity from the child is, resulting in a greater gift. The gift is the value of the asset transferred less the value attributable to the child's obligation under the contract.

Third, if the parent's actual life expectancy is the same as the IRS tables, the freeze aspect of the annuity will be effective as the transferred assets may be invested by the child at a higher yield than that calculated under Section 7520 of the Code. To compound this benefit, in the event that the parent's life expectancy is somewhat shortened, but the parent is not terminally ill, the number of annuity payments the parent actually receives will be less than the number of payments contemplated under the actuarial life expectancy contemplated under Section 7520. Thus, less in assets will be included in the parent's estate at his death since the unreceived payments will escape estate and gift tax.

Another possibility is to use an annuity agreement that is treated under the proposed regulations as a debt instrument to avoid the new annuity rules altogether. In this event, payments received under the debt instrument would be taxed under the installment method, producing tax deferral until payments are received. In order to use this exception, the annuity that the parent receives in exchange for the transferred property must fit an exception to the annuity rules, and if it does the new annuity will not cause the parent to be taxed in the year of the exchange. The parent would be able to use the installment method. Further, a self canceling installment note has been and continues to be a viable option for exchanges in this context.

CONCLUSION

The restrictions under the new proposed regulations would significantly reduce the benefit to be gained in selecting the private annuity. With careful planning, annuities may still be used, though the benefits have been

curtailed substantially.

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C. Raymond Radigan is a former Surrogate of Nassau County and
Of Counsel to the Firm of Ruskin Moscou Faltischek, P.C.
He is also Chairman of the Advisory Committee to the Legislature on Estates Powers and Trusts Law and the Surrogate's Court Procedure Act.
Adam J. Gottlieb is Of Counsel to Ruskin Moscou Faltischek, P.C., in the Trusts & Estates Department.