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Estate Tax Planning for Persons with Health Challenges

February 16, 2010
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Situations often arise in which successful business persons or otherwise wealthy individuals find their health has deteriorated, resulting in a less than normal life expectancy. Cancer, Lou Gehrig's disease, Alzheimer's, multiple sclerosis, heart disease, and even obesity can substantially reduce a life expectancy. Because the federal estate tax is scheduled to be reinstated beginning in 2011 at a hefty 55 percent for individuals with assets exceeding $1,000,000, many people will have significant exposure to estate tax liability. The use of private annuities and self canceling installment notes in an intra-family exchange of assets are ways to reduce or even eliminate such liability.

Sale of Assets in Exchange for Private Annuity

In a private annuity transaction, a seller (mom or dad) agrees to sell assets to a buyer (son or daughter) in exchange for a fixed series of lifetime payments. If the seller lives a longer life than expected, the buyer overpays for the asset. If the seller dies sooner than expected, the buyer receives a bargain for the assets purchased. The payment amount is based on the frequency (monthly, quarterly or annually), age of the annuitant (mom or dad) and the interest rate. The interest rate is determined by the IRC § 7520 rate for the month in which the sale occurs. This interest rate fluctuates monthly and is currently at historical lows. The actuarial life expectancy of the seller is determined by table 2000CM in Treas. Reg. § 20.2031-7T(d)(7) and can be used even if the actual health of the annuitant is impaired (but not terminal, as discussed below).

Example: Jabba T. Hutt, age 73, has had three heart attacks and is diagnosed as grossly obese. He desires to give $6,000,000 to one of his children in exchange for lifetime annual payments of $656,074. If Jabba T. Hutt dies before the second annual installment is due, he will have been successful in reducing his taxable estate by $5,343,926.

Terminal Illness. The annuitant must not be considered terminally ill at the inception of the sale. An annuitant is considered terminally ill if he or she has less than a 50 percent chance of living for at least one year. Treas. Reg. § 1.7520-3(b)(3). The determination of whether an annuitant was terminally ill at the time of the sale is ultimately the decision of the court, but the parties can bolster their position by acquiring an opinion of a qualified physician at the time of the sale. Even without a physician's statement, if the annuitant lives longer than 18 months, a presumption exists that the annuitant was not terminally ill. Treas. Reg. § 1.7520-3(b)(3). The consequence of a finding that the annuitant was terminally ill is that a taxable gift is deemed to have been made to the purchaser. In the above example, if Jabba T. Hutt were deemed to be terminally ill, he would be deemed to have made a taxable gift of $5,343,926 to his child. However, this result would be no different than if Jabba T. Hutt had kept the $5,343,926 and that amount had been taxed as part of his estate.

Capital Gain. From an income tax perspective, a portion of each payment received by the seller (the annuitant) is considered capital gain pursuant to the rule of IRC § 72. Unrecognized capital gain at the time of death is not subject to tax.

Other Uses. If the seller, along with other members of his or her family, owns stock of a family corporation or an interest in a family limited liability company, a redemption of some or all of the stock or interest can be structured in exchange for a private annuity where the family corporation or limited liability company is obligated to make the lifetime payments. This may be desirable in situations where a son or daughter does not have sufficient resources to make the annuity payments, but a family corporation or limited liability company does. If the interest redeemed is less than a controlling interest, a minority and marketability valuation discount may also apply making the sale even more beneficial from an estate tax planning perspective.

Sale of Assets in Exchange for Self Canceling Installment Note

A disadvantage to the use of a private annuity is that the buyer must continue to make annuity payments even if the annuitant significantly outlives his or her life expectancy. The buyer will not know the final purchase price until the death of the annuitant. A self canceling installment note ("SCIN") remedies the risk to the buyer by capping the amount of the buyer's payments. Thus, the terms of a SCIN typically provide that installment payments cease upon the earlier of a fixed number or years or the death of the seller. To compensate for this mortality risk, the Internal Revenue Service has indicated that the buyer must pay an interest rate premium. GCM 39503 (5/7/86). Determining the proper interest rate for a SCIN is much more uncertain than for a private annuity. In addition, there is no clear authority to ignore the health status of the measuring life (usually, the seller). GCM 39503 (5/7/86), Issue 2(B). If a proper interest rate premium is not selected, the IRS may recharacterize the sale transaction as a partial gift subject to gift tax.

The frequency of SCIN payments can be more flexible than a private annuity. Thus, a SCIN can be structured with increasing or deferred repayment terms such as interest only for six years and equal principal payments over the next four years. This would be ideal *from an estate tax perspective* if the seller were to die prior to the first principal payment.

From an income tax perspective, a part of each payment will be considered interest income and capital gain by the seller. Unlike a private annuity, any unrecognized capital gain at the time of the death of the seller is subject to tax in the seller's estate. *Frane Estate v. Comr.*, 998 F.2d 567 (8th Cir. 1993).

The use of a private annuity or SCIN in the right situation can result in dramatic estate tax savings. Usually, the right situation requires the willingness and cooperation of a person with considerable wealth who is confronted with deteriorating health conditions. Discussions with such a person about estate planning of this nature can be uncomfortable. However, the prospect of considerable estate tax savings resulting in the person being able to pass more of his or her wealth to loved ones can bring comfort to an otherwise uncomfortable situation.