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USE OF THE PRIVATE ANNUITY FOR ESTATE PLANNING

The private annuity is an estate planning device which may be used as a vehicle for transferring property. It has been described as the "sale of property between close or related persons where the buyer agrees to pay a life annuity to the seller instead of a fixed price."[1] The basic objectives of such a transaction are: (1) to transfer property from the estate, (2) to keep the property within the family, (3) to avoid payment of estate and gift taxes, and (4) retention of substantial income by the transferor. These objectives cannot be attained without an understanding of the problems involved in its application.

ESTATE TAX CONSEQUENCES - TRANSFEROR

A private annuity sale is divided into two transactions for tax purposes: (1) the sale of the property and (2) the purchase of an annuity. In exchange for the conveyance of the property the transferee contracts to pay a fixed annual amount to the transferor for life.

In cases involving transfers within the family, the courts will closely scrutinize the transaction to determine if the property should be included in the transferor's estate.[2] A statutory presumption of a transfer in contemplation of death arises if the transferor dies within three years of the transfer.[3] Thus, if it is apparent from the health of the annuitant-transferor that his actual life expectancy is quite short at the time of transfer and death occurs within three years, the presumption would be difficult to rebut.[4] It is suggested that at the time of transfer a medical examination of the transferor be made and a written record of it retained to dispell any inference of a "contemplation of death" transfer. If the transferor retains the right to the income from the

1. Farmer, **Private Annuities**, 101 Trusts & Estates 28 (1962).
2. Hill's Estate v. Maloney, 58 F. Supp. 164 (1944); see I APPLEMAN, BASIC ESTATE PLANNING 302 (1957).
3. Int. Rev. Code of 1954, Sec. 2035.
4. United States v. Wells, 283 U.S. 102 (1931).

property[5] or the annuity payments are measured by the income from the property[6] the transfer may be considered a conveyance with a retained life interest and therefore includible in his estate.[7]

In order to avoid such inclusion, it is important that the transfer be unconditional and complete upon the execution of the contract.[8] The annuity payments should be the personal obligation of the transferee and not measured by the income from the transferred property.[9] Thus, the transferee should be of sufficient means to meet the payments regardless of the income produced by the property.[10] A security device held by the transferor on the property may be regarded as a reversionary interest[11] and therefore, includible in the transferor's estate.[12]

The transfer agreement may provide for a joint and survivor annuity, that is, to the father and mother for their joint lives and then to the survivor for life. If such an agreement is entered into, the estate of the father, if he predeceases his wife, will include only the actuarial value of his wife's right to the annuity.[13]

INCOME AND CAPITAL GAIN TAX CONSEQUENCES - TRANSFEROR

Because the transaction involves a "sale" of the property, the question of whether the transferor realizes a gain or loss upon transfer arises. In the field of private annuities where the transferee is an individual not ordinarily engaged in writing annuities, the courts have consistently held that no taxable gain or loss arises to the annuitant at the time of the exchange because the promise of the transferee has

5. Estate of Daniel McNichol, 265 F.2d 667 (3rd Cir. 1959). (Where the conveyance appeared to be absolute but an oral understanding that the transferor would retain income from the property resulted in its inclusion within the transferor's estate); Green v. United States, 237 F.2d 848 (7th Cir. 1956).

6. Estate of Cornelius Schwartz, 9 T.C. 229 (1947).

7. Int. Rev. Code of 1954, § 2036.

8. Hill's Estate v. Maloney, **supra** note 2; Hirsh v. United States, 35 F.2d 982 (Ct. Cl. 1929); Evans v. Comm'r, 30 T.C. 798 (1958).

9. Estate of Koert Bartman, 10 T.C. 1073 (1948).

10. **Ibid.**

11. See N.Y.U., 12th Inst. on Fed. Tax. 721, 731 (1954).

12. Int. Rev. Code of 1954, § 2037.

13. Int. Rev. Code of 1954, § 2039; the private annuity is valued for estate tax purposes in accordance with Treas. Reg. § 20.2031-7 (1958).

no ascertainable fair market value.[14] If the transferee is an organization such as a corporation, trust, fund or foundation not ordinarily engaged in the practice of writing annuities, the transferee's promise will be valued according to the Commissioner's Tables under Rev. Rul. 62-137 supplemented by Rev. Rul. 62-216.[15] These tables will result in a valuation similar to the standards of valuation of an annuity contract issued by a commercial insurance company.[16] If the individual transferee's promise is supported by a security device so that the payments by the transferee are not completely dependent on the transferee's solvency, the annuity promise may be valued as a commercial annuity for income tax purposes.[17]

As previously stated, where the transferee is an individual and the transferee's promise is unsecured, no taxable gain to the transferor arises at the time of transfer. Instead, the amount received each year by the transferor is taxed according to the general annuity rules under the 1954 Internal Revenue Code.[18] The transferor's total investment in the annuity contract is the fair market value of the property at the time of the exchange provided there is no element of gift.[19] An element of gift is present if the fair market value of the property does not approximate the actuarial value of the annuity.[20] The above rule is based on the sale-purchase theory in that the transferor is deemed to have sold the property receiving the fair market value and then used the receipts in purchasing an annuity.[21]

Applying the general annuity rules to the payments received, the transferor determines what portion of each year's payments represents a return of capital. This is computed by multiplying the agreed upon annual payment times the transferor's life expectancy to arrive at the

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14. Comm'r v. Kann's Estate. 174 F.2d 357 (3rd Cir. 1949); Frank C. Deering, 40 B.T.A. 984 (1939); J. Darsie Lloyd, 33 B.T.A. 903 (1936); Rev. Rul. 239. 1953-2 Cum. Bull. 53.
15. Rev. Rul. 62-137, 1962 Int. Rev. Bull. No. 35; Rev. Rul. 62-216, 1962 Int. Rev. Bull. No. 216.
16. **Ibid.**
17. See Wallace, **Taxation of Private Annuities,** 40 B.U.L. Rev. 349, 354 (1960).
18. Int. Rev. Code of 1954, § 72; Treas. Reg. § 1.72-2 (1960); Jane J. de Canizares, 32 T.C. 345 (1959).
19. Jane J. de Canizares, 32 T.C. 345 (1959).
20. See Estate of Sarah Bergan, 1 T.C. 543 (1943).
21. Hill's Estate v. Maloney, **supra** note 2.

transferor's expected total return. Then, the transferor's investment in the contract is divided by his expected total return to arrive at the excluded percentage of each annual payment which represents a return of capital. This "capital return" amount of the annual payment, which remains constant for the duration of the transferor's life, is excluded from the transferor's income each year until he has recovered his adjusted cost basis for the property. Then, if the value of the property transferred has appreciated, the excluded amount is taxed as capital gain until the full amount of the appreciation has been taxed. At this point the exluded portion again becomes tax-free. The remainder of each payment is taxed as ordinary income.[22]

If the fair market value was less than the annuitant's adjusted basis the loss incurred upon transfer would not be deductible in the year of exchange.[23]

The effect of the above rules is that a large portion of the payments will be tax-free until the basis of the property is recovered. Subsequently, when the excluded portion is considered capital gain, the annuitant is only taxed at the time he receives each payment and consequently the tax is postponed and spread out.

In computing the annuitant's income tax for the year preceding death, no loss is deductible if, upon the death of the annuitant, he has not recovered his cost.[24] In *Industrial Trust Co. v. Broderick* the court said that the transaction was not entered into for profit; the annuitant was seeking financial security during his lifetime and therefore he has received what he bargained for.[25]

The following example will illustrate the application of the above rules. Mr. Jones owns 300 acres of land with an appraised valuation of $200 per acre. The property has a cost basis of $25,500. Jones conveys the farmland to his son in return for the son's promise to pay to Mr. and Mrs.

22. Rev. Rul. 239, **supra** note 14, illustrates the application of the general annuity rules under the 1939 Int. Rev. Code.

23. Evan's v. Rothensies, 114 F.2d 958 (3rd Cir. 1940).

24. Industrial Trust Co. v. Broderick, 94 F.2d 927 (1st Cir. 1938); see Helvering v. Louis, 77 F.2d 386 (D. C. Cir. 1935).

25. 94 F.2d 927, 930 (1st Cir. 1938).

Jones jointly and to the survivor, for life, the sum of $3,000 annually, payable monthly.

The life expectancy multiple, based on the joint lives of Mr. Jones (age 64) and Mrs. Jones (age 67), is 21.5.[26] Therefore, the expected total return is 21.5 times $3,000 or $64,500. Dividing the investment in the contract, $60,000, by the expected return of $64,500 we arrive at 93 per cent, the percentage of each payment excluded from the payment as a return of the investment. The following chart will illustrate the tax consequences of the above example:

SCHEDULE A

	Tax Free	Capital Gains	Taxed Income
1st thru 9th year	$2,790	—0—	210
10th year	90	2,700	210
11th thru 21st year	—0—	2,790	210
22nd year	1,380	1,410	210
thereafter	2,790	—0—	210

The above illustration would normally hold true if the actuarial value of the annuity was approximately equal to the fair market value. But here, due to the advanced age of Mr. and Mrs. Jones, the actuarial value of the annuity is considerably less than the fair market value of the property and therefore an element of gift is present.

GIFT TAX CONSEQUENCES - TRANSFEROR

As stated previously, the Internal Revenue Service will be alert to the possibility of asserting estate taxes in intra-family transactions. The same holds true where there is a possibility of gift tax liability.[27] In the latter instance, contrary to the procedure used for income tax purposes applicable to private annuities, the actuarial value of the annuity[28] is used in determining any gift tax liability.[29]

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26. Treas. Reg. § 1.72-9, Table II (1956), as amended, T.D. 6233 (1957).
27. **Supra** Note 20.
28. Treas. Reg. § 25.2512-5.
29. Estate of Koert Bartman, **supra** note 9; Edmund A. Steenburg, 41, 184 P-H B.T.A. Mem. Dec. (1941).

Because the fair market value at the date of the transfer is deemed to be the cost of the annuity it is advisable that the transferor obtain a qualified appraisal of the property to be transferred. A mere unfounded estimate may result in subsequent problems. Where this fair market value is equal to the value of the annuity, normally no gift tax problems arise.[30] An exception is where the health of the transferor at the time of exchange is such that he could not possibly fulfill his life expectancy.[31] Then the actuarial valuation would yield to the realities of the particular case.[32]

Where the value of the property is greater than the value of the annuity the excess may be taxable as a gift at the time of the exchange.[33] In that case the transferor should, by the use of the Commissioner's Tables, actuarially determine the value of the annuity and pay a gift tax on the excess at the time of the exchange.[34] Proper use of the transferor's gift tax exemption and exclusions will minimize the effects of the gift tax. The gift tax will be insignificant compared to the estate tax consequences if the transferor did not treat this excess amount as a gift.[35] The transaction would be open to attack by the I.R.S. as an illusory transfer.[36] It should be noted that when a portion of the property transferred is treated as a gift, the transferee's basis may be correspondingly reduced.[37]

If the annuity is joint there will be a gift tax on the value of the right to present payments vested in an annuitant who did not contribute sufficient consideration to equal the value of such payments.[38] Where the non-contributing annuitant is a spouse the marital deduction may be used advantageously.[39]

The earlier example can be used to show the application

30. See Int. Rev. Code of 1954, § 2512 (b); Treas. Reg. 25.2512-8 (1958).

31. Estate of N. M. Butler, 18 T.C. 914 (1952); Huntington Nat'l Bank of Columbus v. Commissioner, 13 T.C. 760 (1949); Estate of Nellie H. Jennings, 10 T.C. 323 (1948).

32. **Ibid.**

33. Estate of Koert Bartman, **supra** note 9; Estate of Sarah Bergan, **supra** note 20.

34. Estate of Koert Bartman, **supra** note 9.

35. **Compare** Int. Rev. Code of 1954 § 2502, **with** Int. Rev. Code of 1954 § 2001.

36. See Ekman, **Private Annuities**, 22 Ohio St. L.J. 279, 287 (1961).

37. Treas. Reg. § 1.1015-4 (1957).

38. Rev. Rul. 55-388, 1955-1 Cum. Bull. 233.

39. See Int. Rev. Code of 1954, § 2523.

of the above rules to a gift tax situation. The value of an annuity is determined by multiplying the expected annual return times the applicable actuarial factor.[40] In our example the factor for the present worth of $1.00 per annum payable annually until the last of two persons (age 64 and 67) to die is found to be 12.2697. Based on $3,000 per annum payable annually, the present worth of the annuity to be paid to Mr. and Mrs. Jones is $37,393.[41] Thus, it can be seen that the consideration of $60,000 (fair market value of the property) is much greater than the $37,393 value of the annuity. Hence, it would be advisable for Mr. Jones to treat the value of the annuity as his investment in the contract and to treat the excess consideration of $22,607 as a gift at the time the transaction is entered into. Using $37,393 as the investment in the contract and dividing the figure by the expected return of $64,500 (joint life expectancy of 21.5 times $3,000) the new exclusion ratio is 57.97 per cent. Therefore the annual amount excluded is 57.97 per cent of $3,000 or $1,739.10. The taxable income would amount to $1,260.90 annually. The following schedule illustrates the taxable effect on the annual payments for the life expectancy of Mr. and Mrs. Jones.

SCHEDULE B

Year	Tax-free	Cap. Gain	Taxed Income
1 thru 14	$1,739.10	—0—	$1,260.90
15th	852.60	886.50	1,260.90
16 thru 21	—0—	1,739.10	1,260.90
22nd	867.20	871.90	1,260.90
Thereafter	1,739.10	—0—	1,260.90

TAX CONSEQUENCES - TRANSFEREE

Because a private annuity sale is not a completed transaction until the death of the annuitant the fixed cost of the property acquired by the transferee cannot be determined until the payments are terminated by the death of the annuitant. At that time the transferee's cost is the total amount of annuity payments actually made to the transferor during the transferor's lifetime.[42]

40. **Supra** note 28.
41. Adjusted for monthly payments.
42. Forrester v. Comm'r, 4 T.C. 907 (1945); Dana S. & Marie G. Beane, 56,008 P-H Tax Ct. Mem. (1956).

But where the property is depreciable or the transferee desires to sell the land while the annuitant is still living, a cost basis for the property must be established. The method for determining this basis is discussed thoroughly in Rev. Rul. 55-119.[43]

The ruling provides that the basis is the annual payment required under the annuity contract multiplied by the annuitant's life expectancy. This assumed cost is used for determining the allowance for depreciation. When the payments actually made exceed this basis the annual payment is then added to this basis and the excess is depreciated over the remaining life of the property. Upon the death of the annuitant the unadjusted basis for depreciation of the property is the total of the payments actually made.

Where the property is sold during the lifetime of the transferor, the transferee's basis for determining gain upon the sale is the amount of payments actually made plus the actuarial value of the prospective payments from the date of sale. If the sale price is greater than this assumed cost basis the excess is taxable as a gain from the sale. When determining loss upon such a sale, the basis is the total payments actually made at the time the property is sold. Where the selling price is less than the basis for gain and greater than the basis for loss, neither gain nor loss is recognized when the property is disposed of.

If the original transferee continues to make annuity payments after the sale and the total amount of payments, both before and after disposition, exceeds the basis used for determining gain or loss on the sale, he may deduct the payments as a loss in the year, or years, in which paid. Thus, where the loss was recognized on the sale, all subsequent annuity payments are deductible as losses for income tax purposes. If neither gain nor loss was recognized at the time the property was disposed of no loss is deductible until the total payments made under the contract, decreased by depreciation, exceed the selling price.

Where a gain was recognized on the sale of the property

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43. 1955-1 Cum. Bull. 352.

while the annuitant was still living and the total payments made up to the time of the annuitant's death were less than the basis for computing such gain, the excess of the basis over the total annuity payments is taxable as income to the transferee in the year the annuitant dies. Obviously, if a loss was recognized at the time of the sale there will be no gain, but if neither gain nor loss resulted from the sale and the total annuity payments actually made less depreciation is less than the selling price, the excess of the selling price is taxable income to the transferee in the year the annuitant dies.

From time to time the question has arisen as to whether the transferee-payor can deduct any part of the payment as interest on the debt. However, the courts have consistently held that each payment is a capital expenditure and therefore is not deductible as interest expense or as a loss.[44] This rule applies whether the transferee-payor is an individual or a corporation.[45]

If the transferee-payor predeceases the transferor-annuitant, the transferee's estate is obligated under the annuity contract and the transferor becomes a general creditor of the estate.[46] This obligation of the transferee's estate could be provided for through the use of life insurance payable to either the transferor or to the transferee's estate.

CONCLUSION

The selection of this medium for estate planning purposes should involve a detailed and careful analysis of the family situation to which it will be applied. Certain family circumstances may not warrant the use of the private annuity. An obvious example would be the prospective transferee's inability to properly manage the property to be transferred. Under proper circumstances the tax advantages are very attractive. Income from the property owned by a transferor in a high tax bracket would be shifted to the presumably

44. Steinback Kresge Co. v. Sturgess, 33 F. Supp. 897 (D.C.N.J. 1940); Scott v. Commissioner, 29 F.2d 472 (7th Cir. 1928); Kaufman's Inc., 28 T.C. 1179 (1957); Victor J. Evans, 23 B.T.A. 156 (1931).

45. Steinback Kresge Co. v. Sturgess, **supra** note 44; Scott v. Comm'r, **supra** note 44.

46. 1 APPLEMAN, INSURANCE LAW, § 82 (1941).

lower income tax bracket of the transferee. This tax saving ordinarily would be offset only to a minor degree by the income tax paid by the annuitant-transferor on a small portion of the annuity income. Further, the transferred property would be diverted from the presumably high estate tax bracket of the transferor, thus reducing the cash requirements of the transferor's estate.

In conjunction with these tax advantages, the private annuity is an instrument which can accomplish one of the prime objectives of estate planning — retention of essential income-producing assets within one's family.

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