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PRIVATE ANNUITIES GO PUBLIC

Private annuities, when appropriate and structured properly, offer a unique convergence of income tax and estate/wealth transfer planning opportunities. This commentary will examine (1) some practical considerations in the use and design of private annuities, (2) the overall tax consequences of the transaction to the transferor and transferee, and (3) the use of life insurance in conjunction with a private annuity.

PRIVATE ANNUITY DEFINED

A private annuity is an agreement between two parties, neither of whom is in the business of selling annuities, under which the transferor (annuitant) transfers complete title to property (usually a capital asset) to the transferee (annuity obligor). The transfer is made in exchange for the transferee's unsecured promise to make fixed, periodic payments (annually, semi-annually, quarterly, or monthly) to the transferor, typically for the life of the transferor. Payments are calculated based on IRS rules, rates, and life expectancy tables.

Example: 65-year-old Henry agrees to transfer farmland worth $1,000,000 (with an adjusted basis of $100,000) to his son, Bill. In return, Bill promises to pay Henry a fixed monthly amount for as long as Henry lives (that is, a single life-only annuity payable on a monthly basis).

Note the five basic elements of a private annuity highlighted in this example:

First, the parties have entered into a legally binding contract that makes one party (the transferor-annuitant) a general creditor of the other party (the transferee-obligor).

Second, the parties to the arrangement are related – as most private annuities are between family members (e.g., parent and child). However, a private annuity can be structured between a corporation (or trust) and an individual, or between an estate and a corporation (whereby the estate sells property or stock in return for payments by the corporation for the life of the estate's sole beneficiary), or even between a corporation and a retiring shareholder (as part of a buy-sell agreement). In the latter case, the annuity payments are made in lieu of the typical lump-sum or installments redemption. [NOTE: For situations involving stock redemption, care should be taken that private annuity arrangements do not trigger the application of "family attribution" rules.]

Third, the transferee is not a person or company engaged in the business of selling annuity contracts, even occasionally; otherwise, the excess of the present value of the annuity over the transferor's adjusted basis in the property would be immediately taxable. A major advantage of a properly structured private annuity is that the tax on the gain may be deferred and prorated over the life expectancy of the transferor.

Fourth, the moment the private annuity agreement is signed, all legal title to the property in question passes to the transferee. That person may then sell, mortgage, or dispose of the property as he/she wishes. The sole security the seller-transferor has is as a general creditor of the buyer-transferee. The retention of any security interest in the transferred property would trigger adverse income and possibly estate tax consequences (discussed below).

Fifth, the transferor is paid through a systematic liquidation of principal and interest over a specified period of time, that is, in the form of an annuity. Typically, a private annuity continues for the lifetime of the transferor-annuitant. So, annuity payments end when the transferor dies.

PRIVATE ANNUITY DISTINGUISHED FROM A LIFE ESTATE

The life tenant of a life estate holds the right to use, possess, and enjoy property or the income from the property; however, there are significant differences between a private annuity and a life estate. Notably, unlike a private annuity which provides the transferor with a predetermined and fixed annuity for life, a life estate provides no guarantee of a specified amount of income to the life tenant. It pays only as much income as the property supporting it earns from time to time; therefore, if the property earns less, the life tenant receives less, and vice versa.

WHEN IS A PRIVATE ANNUITY INDICATED?

There are numerous instances where a private annuity should be among the tools and techniques considered. Some of the typical case scenarios or planning objectives (with which many planners/advisors are familiar) include:

1. A private annuity is indicated when a client owns appreciated property he/she would like to dispose of, but wants to avoid recognition of the taxable gain in a single year. Under JGTRRA 2003, the current top long-term capital gains tax rate is 15%. Through a private annuity, the transferor obtains tax leveraging by (1) spreading the taxable gain (either ordinary or capital) – therefore, prorating or "deferring" the tax – over his/her life expectancy; and (2) lowering the income tax bracket (for example, assuming the client has retired and has less (or no) earned income when annuity payments are received, or has deductions that can offset the tax on the gain).

2. Your client owns a business or other key asset and wants to retire from the business or dispose of the asset. He/she cannot afford to give it away, but may be willing to sell his/her control and ownership of the business or asset to family member(s) or trusted long-service employee(s) who might otherwise not be able to purchase it for a lump sum. In other words, a private annuity may help turn an otherwise unmarketable asset into a stream of income. For example, your client is a widow who owns unimproved but highly appreciated farmland that is currently providing little or no income. She could keep the property in the family, receive a fixed income for life, and pay capital gains tax prorated over her life expectancy – by selling it to her child/children in return for a private annuity.

3. An estate owner is interested in capping or reducing the growth in his/her estate and shifting future appreciation (of certain assets) to children and grandchildren. He or she can sell a business or appreciating property or other asset (or an interest in a business or property), to a child (or children) in return for a private annuity. From the moment the private annuity is executed, all future growth in the business or asset occurs in the hands of the child (or children).

   The client has effectively reduced or "frozen" his/her estate value by removing the asset from the estate and shifting its subsequent appreciation to the next generation without incurring a gift tax. This is because the transaction, if properly structured, is a sale and not a gift. Likewise, the client may enter into a private annuity arrangement with his/her grandchild (or grandchildren), without having the transaction be subjected to the generation-skipping transfer tax.

4. A corporate client would like to buy-out the stock interest from a deceased shareholder's estate, or from a living/retiring shareholder. The corporation could pay a private annuity in return for the stock. The same technique can also be effective for cross-purchase arrangements between shareholders.

5. You client wants to diversify his/her assets but does not want to incur tax on the gain all in one year. Through a private annuity, the client could sell business interests or other investments to a child or children who in turn could immediately sell that asset – at little or no current gain. The proceeds could then be used to purchase a number of other investments.

6. Your client is a widower who has a lifetime general power of appointment over assets in a marital deduction (A) trust. One of those assets is unimproved real estate that is rapidly appreciating but producing relatively little income. The widower could instruct the trustee to exchange the land for a promise to pay him an income for life. The transferee could be one or more of his children or the trustee of a non-marital (B) trust. The trustee could then develop the land, make it income producing, which would help the transferee make the promised payments.

   This gives the widower more income, removes an appreciating asset from his estate, and incurs no gift or estate tax cost. [NOTE: If this technique is used and the transferee is the non-marital (B) trust, the trustee of that trust should be specifically authorized by the trust provision(s) to enter into the private annuity. Trust terms should specify the names or classes of potential annuitants. The private annuity arrangement should only be implemented after the terms and the annuity computations have been reviewed, verified and approved by counsel to the non-marital (B) trust. The trustee should be exonerated from personal liability to current and future parties to the private annuity agreement.]

POSITIVE INDICATORS

Generally, private annuities work best and provide the desired results for both the transferors and transferees if the following are present:

1. The transferor has a sizable estate such that realistic (and substantial) estate tax savings can be achieved by the removal of the asset/property from his/her estate.

2. The transferor trusts the transferee to make payments on a timely basis.

3. The transferor can spend or give away annuity payments once received.

4. The transferor has a significant source (or sources) of financial security other than the transferred property. Private annuity should not be used if the property in question is the sole or major source of the transferor's financial security.

5. The transferred property should be highly-appreciated (or appreciating), and not subject to depreciation recapture or investment credit recapture, or indebtedness.

6. The transferee has the ability (that is, financial resources) to make the promised annuity payments – without hardship. Otherwise, the transferred property should be income-producing, or one that can be readily sold or borrowed against by the transferee. [NOTE: The annuity payments should not be tied to the income generated by the property or to the sales/loan proceeds from the property.]

7. The transferor's health is less than average but he or she is likely to live long enough to justify the use of government tables in determining the annuity payment. Otherwise, the IRS may contend that, because of the transferor's limited life expectancy, the transferor has accepted too little in return for the property and, in essence, made a gift to the transferee.

8. In fact, relevant regulations stipulate that government tables must be used regardless of the annuitant's health or physical condition unless death is "imminent." On the other hand, the tables may not be used if the individual is "terminally ill." The term is defined as a person who has an incurable illness or other deteriorating physical condition and at least a 50% probability of dying within one year. However, if such an individual survives for 18 months after the transaction, the individual is not presumed to have been terminally ill at the time of the transaction, unless the contrary is proven with clear and convincing evidence.

9. The transferor is willing to pay for the services of an independent professional appraiser to value the property to be exchanged for the transferee's promise to pay.

INCOME TAX ASPECTS OF GAIN (OR LOSS)

When an owner exchanges (disposes of) his/her property in return for the promise of annuity payments for life, it is a taxable transaction which results in the recognition of gain (or loss).

The gain (or loss) is determined under the general rule that gain is equal to "the amount realized" minus the seller's "adjusted basis."

[NOTE: Loss deductions are unlikely since properties/assets transferred in return for private annuities are typically highly appreciated. Furthermore, if the parties involved are related (which is often the case), loss deduction will be precluded because it is specifically barred for "intra-family sales."]

The amount realized by the transferor is equal to the present value of the annuity (i.e., the transferor's expected return). Briefly, the calculation is based on factors such as: the Section 7520 rate (for the month the private annuity is entered into); the transferor's age (which in turn determines the annuity factor and life expectancy from applicable tables); the frequency of annuity payment; the transferor's basis in, and the fair market value of, the property. The adjusted basis is generally the transferor's investment in the property sold, i.e. the transferor's cost.

Gain will be ordinary income or capital gain, depending on the nature of the property, the transferor's holding period, and whether any recapture is involved. Generally, the property involved will be long-term capital gain property.

Gain will be prorated over the life expectancy of the transferor – and taxed as part of the taxable portion of each annuity payment. For example, if the transferor's life expectancy is ten years and the capital gain realized is $100,000, the transferor will report $10,000 of the annuity payment as capital gain each year for 10 years.

Note that if the transferee's promise is in any way formally "secured," the transferor will not be allowed to defer and spread out the reporting of the gain, but will be required to recognize it all in the year of the transfer. This is why it is so important to keep documents and records as proof that the transferee's good faith promise and not any formal security interest that stands behind the private annuity payments.

INCOME TAX ASPECTS OF ANNUITY

In addition to recognition of any gain, a transferor must also report any annuity income. Section 72 rules are used for this purpose. Specifically, the familiar annuity exclusion ratio applies.

The bottom line is that each payment received by the transferor is separated into three parts: (1) gain (usually long-term capital gain), (2) tax-free recovery of capital, and (3) ordinary income.

Example: Assume that Henry is 65. He transfers property worth $1,000,000 to his son Bill in return for a private annuity of $7,477 each month payable for Henry's lifetime. Henry's adjusted basis in the transferred property is $100,000.

Assuming a Section 7520 rate of 4.60%, the results are:

Annuity Factor	10.9169
Payout Frequency Factor	1.0209
Initial Annual Payout	$89,726
Monthly Payment	$7,477
Life Expectancy – Age 65	20 Years
Initial Tax-Free Portion:	$5,000
Initial Capital Gain Portion	$45,000
Initial Ordinary Income Portion	$39,726

The step-by-step calculation is as follows:

STEP 1: COMPUTE THE EXCLUSION RATIO:

$$\frac{\text{Adjusted Basis (\$100,000)}}{\text{Annual Payment (\$89,726) x Life Expectancy (20) = \$1,794,520}}$$

Exclusion Ratio (expressed as Percentage): 5.57%

STEP 2: COMPUTE THE TAX FREE RECOVERY OF CAPITAL AMOUNT

Tax Free Recovery of Capital (5.57% of 89,726) = $5,000

STEP 3: COMPUTE THE INITIAL CAPITAL GAIN AMOUNT

Capital Gain ($1,000,000 - $100,000) = $900,000/20 = $45,000

STEP 4: COMPUTE THE ORDINARY INCOME AMOUNT

Ordinary Income [$89,726 – ($5,000 + $45,000)] = $39,726

TAXATION AFTER LIFE EXPECTANCY REACHED

Assuming the transferor-annuitant continues to live beyond life expectancy, he/she will have reported all his/her capital gain, and recovered all his/her basis. So from that point on, the entire amount received will be ordinary income.

Remember that the transferee-buyer's obligation to make payments continues for as long as the transferor lives. Therefore, if the transferor outlives his/her life expectancy, payments must still be made until the transferor's death.

If the transferor dies before reaching life expectancy, no deduction is allowed on his/her final income tax return for any unamortized investment in the contract.

GIFT TAX CONSEQUENCES OF THE TRANSFER

If the transferor gives up more than he/she/it gets, the difference is a gift to the transferee – all in the year of the transfer. Stated more technically, the excess of the property's fair market value over the present value of the annuity to be received constitutes a gift from the transferor to the transferee. (Conversely, if the transferee pays more than he/she/it gets, the difference is a gift to the transferor.)

For instance, suppose in the example we have been using, Henry transferred property worth $1,000,000 but his son Bill promised his father an annuity each year of only $70,000 a year rather than $89,726. An annuity of $70,000 a year based on a Section 7520 rate of 4.6% has a present value of $780,154 (assuming payments are to be made monthly at the end of each month).

As a result, the entire $219,846 – the difference in the present value ($1,000,000 less $780,154) – will be a taxable gift on the date the private annuity agreement was signed. The gift will be subject to the normal gift tax rules and will qualify for the $11,000 annual exclusion and gift-splitting. This is a "one-time" gift. The value of the gift is based on the amount of the fair market value of the property transferred in excess of the present value of the future income stream payable to the transferor – rather than a series of gifts year by year as payments are made. Therefore, only one gift tax annual exclusion (currently at $11,000) per donor (to each donee) will be available in the year of the gift. Of course, the available lifetime gift tax exclusion amount (of the transferor and his/her spouse, if necessary) may be used.

Note that there will be no gift tax issues as long as the value of what is transferred is equal to the value of what is received, i.e., as long as the fair market value of the property is the same as the present value of the annuity. This requires that the annual payment be found by dividing the Section 7520 rate and the annuity factor into the fair market value of the property.

In the example we have been using, the $1,000,000 fair market value of the property would be divided by the appropriate annuity factor of 10.9169 multiplied by the adjustment factor of 1.0209 (for monthly payment), or 11.1450:

$$\frac{\$1,000,000}{11.1450}$$

The result is $89,726 (or $7,477 monthly).

Beware: The IRS will claim that, if the transferor's rights to the annuity could somehow be defeated, then the annuity would have little, if any, value and the full value of the property transferred is a gift. For instance, the problem would occur if there were a provision in the agreement stipulating that the transferor could only look to a trust for satisfaction of his annuity rights, and the transferee could (and did) dispose of the assets in the trust – after which there would be no annuity payment to the transferor. A similar problem would occur if the agreement limited the payment of the transferor's annuity to income produced by the transferred property, or that payments would be made only as long as the transferee owned the property.

The point is that there must be no limitations on the source or duration of payments if adverse gift, income, and estate tax consequences are to be avoided. The annuity payments should not be set to be equal to the income produced by the transferred property, nor should the source of the annuity payments be limited to the income the transferred property produces, and the transferred property should not serve as security for future payments. The transferor should have no veto power over the subsequent sale of the transferred property by the transferee, and there should be no "repossession on default" provision with respect to the property in the agreement.

ESTATE TAX IMPLICATIONS

Since the transferee's obligation to continue payments ceases at the transferor's death, and since the title to property transferred in a private annuity passes to the transferee immediately upon the execution of the agreement, and assuming the transaction (per se) did not constitute a gift from the transferor, there will be no estate tax inclusion. This ability to eliminate federal (and in many cases state) death tax is one of the most appealing features of a private annuity. From the moment the private annuity agreement is signed, not only the property (and therefore its current value), but all of its subsequent appreciation are removed from the transferor's estate. Again, to achieve this objective, it is essential that the transferee's naked promise be the only security for the transfer; the annuity promise must be unsecured and there must be no requirement that the property (or some other asset) be placed in an escrow or irrevocable trust to secure payment of the annuity by the transferee.

A private annuity is typically a straight, one life annuity which ends on the transferor annuitant's death. But it is possible to create a joint or survivor annuity, or a period certain and life annuity, or a refund annuity. For instance, an annuity may continue to be payable after the primary (or a joint annuitant) dies – until the death of the joint/surviving annuitant. Or, payments are payable for a certain period (e.g., 10 years) or for the life of the annuitant, whichever is longer. Similarly, a refund annuity provides that payments must be made until the total annuity received is no less than a specified amount.

These joint/survivor, period certain and refund annuities have estate tax implications. The commuted value, or the discounted value of any refund or period certain guarantees – determined as of the date of the transferor annuitant's death is includible in the transferor's gross estate – to the extent the payments beyond his/her death are attributable to funds contributed by the decedent. Of course, if the recipient of the post-death annuity payments is the decedent's surviving spouse, the payments could qualify for the estate tax marital deduction – assuming no other person can receive annuity payments at the surviving spouse's death.

INCOME TAX CONSEQUENCES FOR THE TRANSFEREE

Most authorities agree that the transferee will not be allowed an income tax deduction for an "interest" payment – even if there is a specific provision for interest in the private annuity agreement. However, if the property received is depreciable, depreciation deductions should be allowable.

While the transferor annuitant is living, the basis of the property held by the transferee is the present value of the annuity payments for depreciation purposes. If annuity payments are made beyond that present value, they are considered capital additions by the transferee, and can be added to the basis for purposes of determining future depreciation. At the annuitant's death, the transferee's basis is adjusted to the total actual annuity payments made – reduced by any depreciation already allowed. If the property consists of both depreciable and non-depreciable property – such as buildings and land – an apportionment is made based on the relative fair market values of the property.

TRANSFER TAX CONSEQUENCES FOR THE TRANSFEREE

Remember that the obligation to make annuity payments continues as long as the transferor lives – even if the transferee predeceases the transferor, and even after the transferee has disposed of the transferred property. The obligation to continue payments is legally binding on the transferee's estate and, therefore, the present value of future payments is a deductible debt of the transferee's estate.

MAKING IT EASIER FOR THE TRANSFEREE TO PAY THE ANNUITY

Ideally, the transferee is a highly trusted and financially responsible adult individual with an independent source of income that is sufficient to make the promised annuity payments. But it is not always possible for the children or other transferees to afford the entire annuity payment out of current income.

It greatly facilitates the transaction if:

1. The transferor is relatively young. The annuity payments to a younger transferor are lower, and any gain can be prorated over a longer life expectancy. The following table illustrates how much lower the annual payments would be for transferors younger than the one in the example we have been using:

Age 45	$61,065
Age 50	$65,592
Age 55	$71,543
Age 60	$79,362
Age 65	$89,726

2. The property is generating income at a high level. But even if the property produces no income, a portion of it may be sold to help meet the annuity obligation.

3. A separate gift of income-producing property is made prior to the time of the private annuity transaction. For instance, a mother could give her daughter a parking lot just shortly before she sells her daughter an office building in return for a private annuity. The income from the parking lot can help the daughter make annuity payments.

4. A gift element (as described above) can be deliberately built into the private annuity. This would be a “part gift” and “part sale” transaction. In our Henry and Bill example, if Henry transfers property worth $1,000,000 in return for annual payments of only $70,000 rather than $89,726, he has built in a gift of $219,846 – and lowered his son Bill's annual obligation by almost $20,000!

5. Alternatively, Bill could borrow against the property to help him make annuity payments to Henry.

6. In many cases, the transferor should make a series of annual gifts, rather than making a single large gift. Henry could decide, on a year by year and discretionary basis, to make annual gifts up to $11,000 to each of his son Bill, Bill's wife, and their children without incurring current gift tax. This gives Henry more control and the flexibility to judge how much money he personally needs each year – and can make his gifts accordingly.

DOWNSIDES

As is the case with any tool or technique, private annuities have downsides.

These include:

1. All payments cease at the transferor's death – even if only one payment has been made to that point. This, of course, is an advantage to the transferee who is required to pay the annuity, but a disadvantage to the transferors heirs. (If the parties to the private annuity are family members, the heirs could well be the transferee's surviving parent and/or sibling.) Nor is any deduction allowed the transferor's estate for the loss incurred because of the transferor's premature death. Life insurance, as described below, can help alleviate this problem.

2. If the transferor outlives his life expectancy, the transferee might pay much more than the anticipated amount. Should the transferee predecease the transferor, the transferee's estate remains liable to continue the payments. On the other hand, payments made beyond the transferor's life expectancy may still be worthwhile, if they are exceeded by the growth of the transferred asset.

   For example, in one celebrated case involving the DuPont family, senior family members transferred $13.5 million worth of stock to a family-owned holding company in return for a private annuity. The agreement called for payments of $900,000 a year. The senior DuPont lived for 30 years – as a result, over $30,000,000 was paid for the stock originally worth only $13.5 million. But by that point, the stock was worth over half a billion dollars!

3. Because the annuity obligation must be unsecured, the annuitant must take the risk that the transferee could waste away the assets, or be sued by a creditor or former spouse, and lose the assets.

4. If the transferor is unable to consume or give away sufficient portion of the annuity payments, his or her estate value may be increased in spite of the "intentional freeze;" thus, defeating the primary purpose of the transaction.

BULLETPROOFING THE TRANSACTION

As I have noted above, there is no "risk free" or "cost free" estate planning tool or technique, and a private annuity is no exception. A major downside is that the transferor is a mere general creditor of the transferee. The transferor must rely on the transferee's willingness and ability to make the promised payments. But what if the transferee becomes disabled and/or dies? From the transferee's point of view, his estate is legally obligated to continue to pay the annuity until the transferor dies. Where will the cash to pay the annuity come from? Both the transferor and the tranferee's estate will suffer if there is not sufficient income-producing capital to satisfy all the estate's liabilities and continue the promised payments.

Generally, life insurance on the transferee's life may be purchased by an irrevocable trust for his or her family to continue payments in the event of the transferee's death. The sum insured could be tied to the present value of future annuity payments. To avoid any implication that the insurance constitutes "security," the purchase and administration of the coverage should be kept separately and apart from any and all documents or records pertaining to the private annuity.

Life insurance can also be used to provide financial security for the spouse of the annuitant at his/her death, and to equalize the inheritance of other children not party to the private annuity. For instance, if Henry had a daughter, Martha, he could give her a portion of the annuity payment he receives each year from Bill. Martha could purchase and be the owner and beneficiary of life insurance on her father's life.

I have suggested above that a private annuity should be considered where a client is in less than average health but is not terminally ill. As a rule of thumb, I usually consider it if the client's life expectancy exceeds two years. Perhaps the best objective third-party evidence of such life expectancy is the acceptance of that person as an insurable risk (albeit impaired) by a reputable insurer. If the insurer accepts the risk, regardless of the underwriting classification, or the substandard rating, or the extra premium imposed, the issuance of the policy represents impartial and persuasive evidence that life expectancy at that time exceeds two years. This enables the client to use the government rates and tables for the private annuity.

CONCLUSION

Private annuities are a tool in the planner's arsenal that must be considered, along with an installment sale and self-canceling installment note, where estate freeze, or elimination (or reduction) of the estate tax is an important concern. In many cases, a private annuity will provide advantages that no other tool or technique can. It is, of course, essential to obtain the services of a full-time professional valuation expert, an estate planning attorney and CPA familiar with both federal and state laws, and to coordinate their expertise in order to weigh the pros and cons and analyze the appropriateness of this tool, and if it is found to be desirable, incorporate the private annuity into the client's overall planning.