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THE USE OF PRIVATE ANNUITIES IN ESTATE PLANNING: PROBLEMS, OPPORTUNITIES, AND A VIABLE ALTERNATIVE

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A traditional estate-planning tool is the private annuity. The value of a private annuity in estate planning is often overstated in light of the serious tax and nontax consequences which may attend such transfers. This Article will examine the advantages and disadvantages of the private annuity for particular individuals. It also will discuss the split-purchase, which is a viable alternative to the private annuity in many situations.

Basically, a private annuity is an exchange of property by one family member for another family member's unsecured promise to make specific, periodic payments for the balance of the transferor's lifetime.[1] The transferor is termed the "annuitant," the individual who promises to make lifetime payments, the "obligor," and the asset transferred in exchange for the private annuity promise, the "annuity property."

I. THE ESTATE-PLANNING BENEFITS OF A PRIVATE ANNUITY

A private annuity offers a number of major, estate-planning benefits. First, the value of the annuity property and all of its future appreciation are not part of the annuitant's gross estate, although these amounts are partially replaced if payments made during the annuitant's lifetime are unspent at the annuitant's death.[2] Second, the annuity property remains within the family

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1. In the estate-planning context, private annuities almost always are exchanged between family members. Commercial enterprises, however, often sell such annuities and some charitable organizations regularly sell annuities. Commercially-sold annuities and the annuities regularly sold by certain charitable organizations will not be discussed in this Article.

2. I.R.C. § 2033. *See* Helvering v. Estate of Rhodes, 117 F.2d 509 (8th Cir. 1941);

unit, which may be particularly important if the annuity property is an interest in a family-owned business. Third, a private annuity agreement provides income to the annuitant for his entire lifetime, rather than for a limited term of years, assuring him additional support during retirement. In this respect, the private annuity is similar to a transfer of income-producing property, in which the transferor retains a life interest.[3] Fourth, the private annuity relieves the annuitant of the responsibility for managing the transferred assets. This benefit is important if the annuity property is a business interest requiring close, constant attention, which the annuitant, because of health, age, or disposition, no longer can provide. The annuitant, however, can continue to lend advisory management assistance. Finally, the private annuity allows the annuitant to spread the tax on the gain recognized from the transfer of the annuity property over a number of years, rather than requiring payment of the total tax amount in the transfer year. The obligor, on the other hand, obtains an increased basis for purposes of depreciation deductions.[4] All of these estate-planning benefits are appealing, but they must be considered in light of the sometimes harsh income, estate, and gift tax consequences of a private annuity.

II. The Income Tax Consequences of a Private Annuity

The income tax treatment of a private annuity is designed to return to the annuitant the same net ordinary income and capital gains that would have been recognized had the annuity property been sold in exchange for an installment obligation over a period precisely equal to the annuitant's lifetime. The private annuity does not always result in this return, however, and it is not possible at the outset of the transaction to be sure what the annuitant will actually recover: the full value of the asset, more than its full value, or less than its full value.

Estate of Zeitz v. Commissioner, 34 T.C. 351 (1960); Estate of Milner v. Commissioner, 6 T.C. 874 (1946); Rev. Rul. 55-438, 1955-2 C.B. 601.

3. The property, however, is not included in the annuitant's gross estate under I.R.C. § 2036. See note 47 and accompanying text *infra*.

4. See notes 22, 29 & 30 and accompanying text *infra*.

A. *Income Tax Consequences to the Annuitant*

The framework for the income tax treatment of the private annuitant is set forth in Revenue Ruling 69-74,[5] which divides each annuity payment into a capital portion and an annuity portion. The capital portion, representing the amount paid by the obligor for the transferred property, is further divided into a capital-gains portion and a portion representing a return of the annuitant's basis in the property. The portion representing a return of the annuitant's basis is determined under an "exclusion ratio," obtained by dividing the annuitant's investment in the annuity contract by the expected return from the annuity.[6] The annuitant's investment in the contract is the annuitant's basis in the annuity property.[7] The expected return of the annuity con-

5. Rev. Rul. 69-74, 1969-1 C.B. 43. Prior to this ruling the taxation of private annuities was controlled by Rev. Rul. 239, 1953-2 C.B. 53. *See* Meisenholder, *Taxation of Annuity Contracts Under Federal Income Tax,* 40 MICH. L. REV. 1005 (1942).

6. I.R.C. § 72(b); Treas. Reg. § 1.72-4(a)(4) (1956).

7. Rev. Rul. 69-74, 1969-1 C.B. 43. Prior to the 1934 Revenue Act, the annuitant's basis was recovered first, with the balance treated as ordinary income. Revenue Act of 1916, ch. 463, § 4, 39 Stat. 756; Revenue Act of 1926, ch. 27, § 213(b)(2), 44 Stat. 9. The Revenue Act of 1934, however, provided that the annuitant recover three percent of each annuity payment as income with the balance as a return of basis until the full amount of basis had been recovered. Revenue Act of 1934, ch. 277, § 22(b)(2), 48 Stat. 680; Internal Revenue Code of 1939, ch. 1, § 22(b)(2), 53 Stat. 1 (presently codified as I.R.C. § 72); Rev. Rul. 239, 1953-2 C.B. 53.

Arguably, the annuitant's investment in a private annuity contract should be the fair market value of the transferred asset, rather than the annuitant's adjusted basis, as required by Rev. Rul. 69-74, 1969-1 C.B. 43. First, the investment in a commercial annuity contract is the value of the consideration paid for the contract, rather than the annuitant's basis. I.R.C. § 72(c)(1)(A). Second, a regulation, issued subsequently to Rev. Rul. 69-74, 1969-1 C.B. 43, states that the investment in a private annuity contract purchased from a church not regularly selling private annuities is the value of the annuity property, rather than its basis. Treas. Reg. § 1.1011-2(c), example 8 (1972). *See* Stewart, *Private Annuities—Revenue Rule 69-74 Partially Repudiated, Sub Silentio, by Treasury Regulation § 1.1011-2(c), Example (8),* 24 MERCER L. REV. 585 (1973). There seems to be no reason why a different rule should apply to private annuities purchased from a church that does not frequently sell private annuities, than applies to the standard intrafamily private annuity. Finally, when a private annuity fails to qualify for pro rata recognition of the total gain, the Tax Court has held that the annuitant's investment in the contract is the entire value of the consideration furnished. 212 Corp. v. Commissioner, 70 T.C. 788 (1978); Estate of Bell v. Commissioner, 60 T.C. 469 (1973); Commissioner v. John C. Moore Corp., 15 B.T.A. 1140 (1929) (Nonacq. VIII-2 C.B. 67 (1929)), *aff'd,* 42 F.2d 186 (2d Cir. 1930). *See* Croft & Hipple, *Planning Lifetime Property Transfers: Private Annuities, Installment Sales, and Gift-Leasebacks,* 11 REAL PROP. PROB. & TR. J. 253, 265-69 (1976); Magram, *The Use of Private Annuities Under the 1976 Tax Reform Act,* in THIRTIETH ANNUAL INSTITUTE ON FEDERAL TAXATION 655, 671-73 (1978); Warwick, *Pri-*

tract is the product of the taxpayer's actuarial life expectancy[8] and annual annuity payments.[9] This exclusion ratio, once established, applies to all annuity payments received during the annuitant's lifetime if the annuitant recovers his actual basis in the asset.[10]

The capital-gains portion of each annuity payment is the difference between the present value of the annuity promise and the annuitant's adjusted basis in the annuity property, divided by the annuitant's actuarial life expectancy.[11] When the obligor's payments exceed the fair market value of the annuity property, the capital-gains portion of each payment becomes taxable as ordinary income.[12] The annuity portion of the annuity payment is taxable to the annuitant as ordinary income[13] and represents the "interest" paid by the obligor on the deferred payments. This portion is the difference between the amount of each annuity payment and the sum of the capital-gains portion and the return of basis.[14]

For example, *A* transfers a piece of vacant land to *O* in exchange for *O*'s promise to pay *A* $30,000 a year for *A*'s lifetime. *A* is a sixty-year-old male at the time of the sale; his actuarial life expectancy is 18.2 years.[15] *A*'s adjusted basis in the land is $100,000.

First determine the exclusion ratio:

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vate Annuities: An Old Tool in a New Era, 1978-6 TAX MANAGEMENT EST. GIFTS & TR. J. 15.

These holdings arguably could be extended to the situation in which pro rata recognition is available. A logical distinction between the two situations can be drawn, however, because, in the situation in which the Tax Court requires immediate recognition of the entire gain, the taxpayers have "earned" their investment in the contract by reporting it as income.

8. Actuarial life expectancies are found in the tables in Treas. Reg. § 1.72-9 (1956).

9. Rev. Rul. 69-74, 1969-1 C.B. 43.

10. *Id.*

11. *Id.* The present value of the annuity promise is normally determined through the appropriate table in the Treasury Department's estate and gift tax regulations, as prescribed by Treas. Reg. § 1.101-2(e)(1)(iii)(b)(3) (1957). Rev. Rul. 69-74, 1969-1 C.B. 43. These tables include a six percent interest factor. Treas. Reg. § 20.2031-10(f), tables A(1), A(2) (1970). The annuitant's life expectancy is determined under the regulations for annuity valuations. Treas. Reg. § 1.72-9 (1956).

12. Rev. Rul. 69-74, 1969-1 C.B. 43, 44.

13. I.R.C. § 72(a).

14. Rev. Rul. 69-74, 1969-1 C.B. 43.

15. Treas. Reg. § 1.72-9, table I (1956).

$$\frac{\text{annuitant's investment in contract}}{\text{expected return}} \quad \text{or} \quad \frac{\$100{,}000}{18.2 \times \$30{,}000} = \frac{\$100{,}000}{\$546{,}000} = 18.3\%$$

Therefore, 18.3% of each annuity payment is a tax-free return of basis, *i.e.,* 18.3% of $30,000 or $5490.

Then compute the capital-gains portion:

$$\frac{\text{present value of the annuity promise}^{16} - \text{adjusted basis}}{\text{anuitant's actuarial life expectancy}} \quad \text{or}$$

$$\frac{\$275{,}259 - \$100{,}000}{18.2} = 9.6\%$$

Therefore, 9.6% of each $30,000 payment or $2880 is capital gain.

Then compute the annuity portion: the amount of each annuity payment minus the sum of the capital-gains portion and the return of basis or $30,000 − ($5490 + $2880) = $21,630. Therefore, $21,630 is taxed as ordinary income.

These rules apply to the single-life, private annuity. A private annuity also may require the obligor to pay a stated amount during the lifetime of the annuitant and his spouse. The income tax consequences of this joint and survivor annuity are similar to those of a single-life annuity, although different tables are used to determine the capital portion of each annuity payment.[17] Again, the exclusion ratio governs all payments to both husband and wife.

The tax treatment of any gain recognized on the exchange of appreciated property for an annuity promise is set forth clearly in the revenue rulings and treasury regulations noted above. The treatment of losses that result when the adjusted basis of the property in the annuitant's hands exceeds the present value of the annuity promise, is less clear. It is difficult to determine whether the loss is recognized pro rata or in the year of the transfer under Revenue Ruling 69-74. Recognition of loss may not be important, since most private annuity losses are nondeductible. If the annuity property is not business or investment property, the loss is a nondeductible personal loss and the year

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16. See note 11 *supra.*

17. *See* Treas. Reg. § 1.72-9, Table II (1956); Rev. Rul. 61-161, 1961-2 C.B. 15.

of recognition is irrelevant.[18] A loss resulting from a transfer between certain family members, which is the type of transfer in most private annuities, is nondeductible under Code section 267.[19] Further, any loss resulting from the annuitant's death prior to his recovery of the full value of the annuity property is a nondeductible loss.[20]

B. *Income Tax Consequences to the Obligor*

The obligor in a private annuity is treated as a purchaser of the annuity property; thus, he realizes no gain or loss at the time of purchase. Serious questions arise regarding the obligor's basis in the annuity property. The Internal Revenue Service has adopted a form of "open basis" theory.[21] The answer to the question "what is the obligor's basis?" begins with the question "when and for what purpose?"

1. The Obligor's Basis During the Annuitant's Lifetime.—The obligor's basis in the annuity property during the annuitant's lifetime is the value of the annuity promise on the date of the agreement, assuming that no portion of the annuity constituted a gift.[22] The obligor's basis is not affected by the amount of his payments to the annuitant during the latter's lifetime, unless the payments exceed the present value of the annuity. The basis for determining gain or loss on a sale of the annuity property prior to the annuitant's death and for determining the obligor's depreciation deductions is increased by the amount of any payments made in excess of the value of the annuity promise.[23]

The obligor's basis in the annuity property for determining

18. *See* Rev. Rul. 71-492, 1971-2 C.B. 127 (personal residence).

19. I.R.C. § 267(a). Included in the family membership group, transfers among which are nondeductible, are "brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants." I.R.C. § 267(b)(1), (c)(4). Losses on transfers between individuals and certain controlled entities, including corporations, partnerships, and trusts, are precluded. I.R.C. § 267(c).

20. Industrial Trust Co. v. Broderick, 94 F.2d 927 (1st Cir. 1937), *cert. denied,* 304 U.S. 572 (1938); Waller v. Commissioner, 39 T.C. 665 (1962) (Acq. 1963-2 C.B. 5); Rev. Rul. 72-193, 1972-1 C.B. 58.

21. Rev. Rul. 55-119, 1955-1 C.B. 352, *applied in* the 1954 Code situation in Rev. Rul. 72-81, 1972-1 C.B. 98. *See* Croft & Hipple, *supra* note 7, at 271-74; Magram, *supra* note 7, at 676-79.

22. Rev. Rul. 55-119, 1955-1 C.B. 352.

23. *Id.* at 353-54.

gain on the sale of the property during the annuitant's lifetime is the sum of the payments made to date plus the present value of the future payments due under the agreement, reduced by any allowable depreciation.[24] The obligor's basis for determining gain is not limited, therefore, to the initial present value of the annuity promise, if the annuitant outlives his or her actuarial life expectancy: the obligor's basis includes the amount of all annuity payments to date.

The obligor's basis for determining a loss on the sale of the annuity property during the annuitant's lifetime is the amount of any payments actually made to the annuitant, less allowable depreciation deductions.[25] The present value of the annuity payments not yet made is disregarded when determining a loss on the sale of the annuity property. After the sale of the annuity property at a loss, an additional loss will be recognized each year that the obligor continues to make payments to the annuitant. A loss is recognized by the obligor even when the obligor's basis at the time the annuity property is sold does not exceed the amount realized on the sale, if subsequent payments to the annuitant raise the total amount paid above the amount realized. The deductibility of the loss is limited by a special rule concerning losses sustained in intrafamily sales.[26]

It is apparent from the divergent basis computations that a sale of the annuity property during the annuitant's lifetime may result in neither a gain nor a loss if the amount realized exceeds the obligor's payments made to the date of the sale, but does not exceed the total of these payments and the present value of the annuity promise. The obligor may realize a loss if the payments made subsequently to such a sale bring the total of all payments, reduced by allowable depreciation, to an amount higher than the disposition price.[27]

2. *The Obligor's Basis After the Annuitant's Death.*—Use of an "open basis" is required by the obligor's inability to determine precisely the amount that the obligor eventually will pay

24. *Id.* at 355. The basis of any property is reduced by allowable depreciation, whether the depreciation is in fact deducted by the taxpayer. Commissioner v. Superior Yarn Mills, 228 F.2d 736 (4th Cir. 1955).

25. Rev. Rul. 55-119, 1955-1 C.B. 352, 354.

26. I.R.C. § 267.

27. Rev. Rul. 55-119, 1955-1 C.B. 352. A loss is realized in the year or years paid.

for the annuity property. This inability ceases upon the annuitant's death when a fixed basis can be ascertained for all purposes.

The obligor's basis in the annuity property after the annuitant's death is the total of all annuity payments made by the obligor.[28] The obligor's basis may be reduced by depreciation and other payments, though apparently no provision exists allowing an immediate recapture of excess depreciation deductions.[29] The excess of the annuity payments made above the present value of the annuity promise increases the obligor's basis for depreciation purposes both before and after the annuitant's death.[30]

A form of "recapture" gain may be charged to the obligor upon the annuitant's premature death if the obligor sold the annuity property at a gain during the annuitant's lifetime. The obligor's basis for determining that gain includes both the payments made to the sale date and the present value of the remaining annuity promise. If the annuitant dies before the obligor has made payments equal to the present value of the annuity promise at the time of the sale, the annuitant's death causes a reduction in the obligor's basis.[31] The obligor must recognize the additional gain under the tax-benefit rule.[32] The character of the additional gain is the same as the character of the initial gain recognized on the sale of the annuity property.[33]

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28. *Id.*

29. The annuitant's premature death may result in creation of a "negative" basis in the annuity property if much of the allowable depreciation taken was predicated upon the present value of the annuity, an amount that never will be paid. This situation could generate significant taxable income if after the death of the annuitant the property were sold or exchanged, since the amount realized would greatly exceed the obligor's basis in the property. I.R.C. § 1001(a). Furthermore, if the property were depreciable, the gain could be ordinary income under the recapture rules of Code §§ 1245 and 1250. Gifts of such negative-basis property could cause an income tax liability if regulations presently proposed by the Treasury Department are adopted. Treas. Reg. § 1.1001-2, (proposed) (40 Fed. Reg. 76,815-16 (1979)). *See* Suwalsky, *Gifts of "Negative Basis" Property,* 1980-2 TAX MANAGEMENT EST. GIFTS & TR. J. 18 (1980). The Treasury is also considering regulations that would impose a tax on the testamentary disposition of such negative-basis property. Legislation and Regulations Division Project 165-79.

30. Rev. Rul. 55-119, 1955-1 C.B. 352, 353-54.

31. *Id.* at 354. The excess of the basis used to determine gain upon disposition of the property over the total of the annuity payments will constitute income in the year of the annuitant's death. *Id.*

32. I.R.C. § 1016.

33. Arrowsmith v. Commissioner, 344 U.S. 6 (1952); Rev. Rul. 55-119, 1955-1 C.B.

3. Deductibility of the Interest Portion of an Annuity Payment.—A portion of each annuity payment is treated as ordinary income to the annuitant.[34] The Internal Revenue Service has ruled that these payments are not deductible by the obligor;[35] this rule has been sustained judicially.[36] The Service's rationale apparently is that the amount paid by the obligor, including the return of basis, the capital-gain portion, and the annuity portion, is bargained-for consideration, rather than payment for the use of money; therefore, it is nondeductible.

III. Gift and Estate Tax Consequences of the Private Annuity

The gift and estate tax consequences of a private annuity should not be overlooked, although they are often subordinate to the income tax considerations. In certain instances, the annuitant may incur significant gift or estate tax liabilities from a private annuity transaction.

A. *Gift Tax Consequences of the Private Annuity*

A private annuity may be a taxable gift, in whole or in part, if the present value of the annuity promise is less than the fair market value of the annuity property.[37] This situation may arise if the parties determine the amount of the monthly or annual annuity payments according to current market interest rate assumptions, rather than the presumed six percent rate in the regulations.[38] The annual payment is lower for the same present value of the annuity property at a twelve percent interest rate,[39] than at the presumed six percent interest rate. A taxable gift

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352.

34. Rev. Rul. 69-74, 1969-1 C.B. 43, 44.

35. Rev. Rul. 55-119, 1955-1 C.B. 352.

36. F.A. Gillespie & Sons v. Commissioner, 154 F.2d 913 (10th Cir.), *cert. denied,* 329 U.S. 781 (1946); Kaufman's, Inc. v. Commissioner, 28 T.C. 1179 (1957); Reliable Incubator & Brooder Corp. v. Commissioner, 6 T.C. 919 (1946). *But see* Commissioner v. John C. Moore Corp., 15 B.T.A. 1140 (1929) (Nonacq. VIII-2 C.B. 67 (1929)), *aff'd,* 42 F.2d 186 (2d Cir. 1930).

37. *See* Rev. Rul. 76-491, 1976-2 C.B. 302 (a private annuity treated as being wholly a taxable gift).

38. Treas. Reg. § 20.2031-10(f), Tables A(1), A(2) (1970).

39. Market interest rates fluctuate; the interest rate on unpaid or overpaid income taxes for 1980 and 1981 will be twelve percent. Rev. Rul. 79-366, 1979-2 C.B. 402.

often results from this method of computation because the Service requires the taxpayer to use the tables contained in the regulations.[40] If it is desirable to avoid making a taxable gift, because, *inter alia,* the annuitant's unified credit has been exhausted and a present tax payment is required, the annuitant should establish the annuity amount from the tables provided in the regulations.

A taxable gift also may occur if the actuarial life expectancy used to determine the annuity payments is excessive. The Service will accept the actuarial tables in the regulations,[41] unless the annuitant is in the advanced stages of a terminal illness with a life expectancy of less than one year. In such a case, the Service requires that the annuitant's actual life expectancy be used.[42]

The Service also rejects the use of actuarial tables if the obligor has very limited assets. In a recent ruling,[43] a taxpayer created a trust, which sold him a private annuity. The trust's assets were precisely enough to pay the actuarially ascertained present value of the annuity. The Service decided that the trust actually had not promised to pay the annuitant a specified sum for life, but rather promised to pay a specified sum for the annuitant's life or the annuitant's actuarial life expectancy, whichever was shorter. Accordingly, the Service used different actuarial tables to value the annuity promise, resulting in a much smaller pre-

40. Fehrs v. United States, 620 F.2d 255 (Ct. Cl. 1980); Rev. Rul. 55-119, 1955-1 C.B. 352. *See* Magram, *supra* note 7, at 679-80.

41. Treas. Reg. § 1.72-9 (1956).

42. Rev. Rul. 66-307, 1966-2 C.B. 429. *See* Estate of Lion v. Commissioner, 438 F.2d 56 (4th Cir.), *cert. denied,* 404 U.S. 870 (1971); Estate of Butler v. Commissioner, 18 T.C. 914 (1952) (Acq. 1953-1 C.B. 3). *But see* Continental Ill. Nat'l Bank & Trust Co. v. United States, 504 F.2d 586 (7th Cir. 1974).

In Rev. Rul. 80-80, 1980-12 I.R.B. 10, the Service reaffirmed its refusal to use the actuarial tables for estate tax purposes when an individual's death was "imminent." The Service, however, clarified its prior position, expressed in Rev. Rul. 66-307, 1966-2 C.B. 429, that it will construe "imminent" in absolute terms, rather than in relative terms. While the Service stopped short of saying that death will not be labeled as imminent unless anticipated to occur within one year, it did state that "[d]eath is not clearly imminent if there is a reasonable possibility of survival for more than a very brief period. For example, death is not clearly imminent if the individual may survive for a year or more and if such possibility is not so remote as to be negligible." Rev. Rul. 80-80, 1980-12 I.R.B. 10, 11.

43. Rev. Rul. 77-454, 1977-2 C.B. 351, 352.

sent value and a partially taxable gift.[44]

A taxable gift also occurs if the annuitant requires the obligor to pay the annuity to some third person, such as the annuitant's child. This transaction constitutes a taxable gift of the present value of the annuity at the time of the agreement.[45] When spouses contribute equally to the purchase of a joint and survivor private annuity, a taxable gift also occurs. The interest of each spouse is determined actuarially, which typically gives the younger spouse the greater interest. In such cases, the older spouse is deemed to have made a taxable gift even though both spouses made equal payments.[46]

B. *Estate Tax Consequences of the Private Annuity*

No estate tax consequences exist to the properly structured private annuity because the annuity promise terminates upon the annuitant's death and no portion of the value of the annuity property is left in the annuitant's gross estate.[47] Because of poor planning, the corpus of a single-life annuity can, in certain instances, be included in the annuitant's gross estate as a transfer with a retained life interest under Code section 2036. Estate planners must be cautious when drafting a private annuity agreement to avoid this result.

Section 2036 includes in a decedent's gross estate the value of property transferred by the decedent during his or her lifetime for other than a full and adequate consideration in money or money's worth, if the decedent retains a right to the lifetime possession or enjoyment of the property. A private annuity may be a transfer includible in the gross estate under Code section 2036 if (1) the annuity payments are substantially identical to the income generated by the annuity property;[48] (2) the annuity

44. *Id.*

45. *See, e.g.*, Treas. Reg. § 25.2512-6(a) (1958). There is no gift, however, if it can be established that transfer of the annuity was made in the ordinary course of business rather than for donative motives. Treas. Reg. § 25.2512-8 (1958). *See* Rev. Rul. 69-74, 1969-1 C.B. 43.

46. Rev. Rul. 76-157, 1976-1 C.B. 306; Rev. Rul. 69-505, 1969-2 C.B. 179. *See* Magram, *supra* note 7, at 689-91.

47. Fidelity-Philadelphia Trust Co. v. Smith, 356 U.S. 274 (1958); Estate of Bergan v. Commissioner, 1 T.C. 543 (1943) (Acq. 1943 C.B. 2); Security Trust & Sav. Bank v. Commissioner, 11 B.T.A. 833 (1928) (Acq. VII-2 C.B. 36); Treas. Reg. § 20.2039-1 (1958).

48. Lazarus v. Commissioner, 58 T.C. 854 (1972) (Acq. 1973-2 C.B. 2), *aff'd*, 513

payments are limited to the income generated by the annuity property;[49] (3) the obligor is not personally liable for the annuity payments, irrespective of the income generated by the property;[50] (4) the obligor has no economic means from which the annuity payments can be made;[51] or (5) the annuitant retains managerial control over the property or its subsequent disposition.[52] The value of the annuity property to be included in a decedent's gross estate under Code section 2036 is the excess of the value of the annuity property on the date of death (or alternate valuation date, if elected) over the consideration received by the annuitant for the annuity property (the present value of the annuity promise).[53] The Service reasons that, to the extent that the annuity property alone funded the repayment, there was no consideration for the promise, and the entire value of the annuity property on the date of death should be included in the annuitant's gross estate.[54]

The survivor portion of a joint and survivor private annuity is always included in the first annuitant's gross estate, even if there was no taxable gift on the purchase of the annuity.[55] An actuarially-determined, ratable share of the value of the annuity property, which is allocated to the survivor's annuity, is included in the first annuitant's gross estate.[56] If the surviving annuitant dies within six months of the first annuitant's death, election of the alternate valuation date reduces the amount of the annuity

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F.2d 824 (9th Cir. 1975). *Cf.* Rev. Rul. 68-183, 1968-1 C.B. 308 (A grantor who had contributed stock to a trust "with a reservation . . . of annual payments of a fixed amount for life" was treated as the owner of the trust under I.R.C. § 677(a) and taxed on all the income. This same reasoning arguably applies in determining estate tax consequences.).

49. Greene v. United States, 237 F.2d 848 (7th Cir. 1956); Rev. Rul. 79-94, 1979-1 C.B. 296. *See* Rev. Rul. 77-454, 1977-2 C.B. 351 (the corresponding gift tax consequences).

50. *Cf.* Rev. Rul. 68-183, 1968-1 C.B. 308, 309 (though the ruling relates to the concept of a retained life interest for purposes of the grantor-trust rules of I.R.C. § 677, it should be equally applicable for purposes of applying I.R.C. § 2036).

51. *Id.*

52. Estate of Holland v. Commissioner, 47 B.T.A. 807 (1942). Because of the court's reliance on a case that was later disproved, this opinion was reexamined and held to be correct in 1 T.C. 564 (1943).

53. I.R.C. § 2043.

54. Rev. Rul. 79-94, 1971-1 C.B. 296. See also Greene v. United States, 237 F.2d 848 (7th Cir. 1956); Updike v. Commissioner, 5 B.T.A.M. (P-H) ¶ 36,062 (1936), *aff'd,* 88 F.2d 807 (8th Cir.), *cert. denied,* 301 U.S. 708 (1937).

55. I.R.C. § 2039(a); Treas. Reg. § 20.2039-1 (1958).

56. I.R.C. § 2039(b); Treas. Reg. § 20.2039-1(b)(2), example 1 (1958).

included in the first annuitant's estate.[57]

The value of the survivor's annuity, which is included in the estate of the first spouse, qualifies for the estate tax marital deduction. Although this annuity is a terminable interest, no other person has an interest in the property that can vest in enjoyment of the property on the death of the surviving spouse.[58] A joint and survivor's annuity, therefore, constitutes an excellent method to fund a marital deduction share because the deduction is awarded for property that is not included in the estate of the surviving spouse.

The private annuity also can be used in conjunction with a two-trust, marital deduction estate plan. In many estates, the surviving spouse can exercise a general power of appointment over the marital deduction share of the estate. This share of the first spouse's estate presumably is included in the surviving spouse's gross estate. The balance of the estate is placed in a second trust, known as the "by-pass," "family," or "nonmarital" trust, over which the surviving spouse can exercise a limited power of appointment. The corpus of this trust is not included in the surviving spouse's gross estate.[59]

It is often useful specifically to authorize the trustee of the marital deduction trust to exchange that trust's assets for a private annuity promise issued by the by-pass trust. This exchange shifts property from the marital deduction trust, the corpus of which is included in the surviving spouse's gross estate, to the by-pass trust, the corpus of which is not included in the surviving spouse's gross estate. The net effect is that the property exchanged for a private annuity is not included in the taxable estate of the first or second spouse. It is important, however, that the trust instrument merely authorize the trustee of the marital deduction trust to make such sales, rather than require the trustee to make them; the latter course results in the disqualification

57. Estate of Hance v. Commissioner, 18 T.C. 499 (1952) (Acq. 1953-1 C.B. 4).

58. I.R.C. § 2056(b)(1)(A). *See* R. STEPHENS, G. MAXFIELD & S. LIND, FEDERAL ESTATE AND GIFT TAXATION ¶ 4.03[4][b] n.61 (4th ed. 1978).

59. This by-pass or family portion of the first spouse's estate is not includible in the surviving spouse's estate because the surviving spouse's interest in the trust corpus is a life estate. It is not includible because the decedent had no interest at the time of his or her demise beyond a limited power of appointment. I.R.C. § 2041(b). *See generally* A. JAMES CASNER, ESTATE PLANNING 743-44 (1979); H. ZARITSKY & M. ZARITSKY, THE NEW ESTATE PLANNING HANDBOOK 106-07 (1980).

of the assets, which must be sold for the marital deduction.[60]

IV. Special Problems in Private Annuity Sales to Trusts

Establishing an irrevocable trust to sell a private annuity to the grantor has become a relatively widespread, estate-planning practice. The grantor of the trust can specify in the trust instrument how the money generated by the annuity can be used. Further, net income from the annuity property can be split between the trust and its various beneficiaries, substantially reducing the total tax burden on that income.

Significant problems may occur with the use of a trust as the obligor of a private annuity promise. These problems most often arise because of inappropriate trust or annuity terms. In one situation,[61] the grantor created an irrevocable trust for the benefit of the grantor's children, funded it with stock in one corporation, and appointed a corporate fiduciary as trustee. The trust then exchanged an annuity promise for the stock of another corporation. The dividends from the two blocks of stock were precisely equal to the annuity promise. The Service, finding that the "sale" was a sham and that the grantor had retained a life interest in the trust stock under Code section 677, ruled that the trust income was taxable to the grantor.[62]

A poor choice of beneficiary powers and annuity terms also led the Service to conclude that no "sale" had occurred and that the entire private annuity exchange was a gift.[63] In this situation, the grantor created a trust, which was required by its terms to pay the annuity amount out of its assets only. A trust beneficiary had a general power of appointment over the trust assets available for payment of the annuity. The Service ruled that the trust was not required to make any payments and that the transfer was a gift.[64]

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60. I.R.C. § 2056(b)(1)(C). *See* Magram, *supra* note 7, at 695-96; Sturm, *The Marital Deduction and a Private Annuity*, 54 Taxes 54 (1976).

61. Rev. Rul. 68-183, 1968-1 C.B. 308.

62. *Id. See* La Fargue v. Commissioner, 73 T.C. 40 (1979). *See generally* Lazarus v. Commissioner, 58 T.C. 854 (1972), *aff'd*, 513 F.2d 824 (9th Cir. 1975); Estate of Schwartz v. Commissioner, 9 T.C. 229 (1947) (Acq. 1947-2 C.B. 4). There is still some question whether this result is correct. *See* Magram, *supra* note 7, at 698-700.

63. Rev. Rul. 76-491, 1976-2 C.B. 302.

64. *Id.*

In two other rulings,[65] the limited character of the trust assets altered the "sale" character of the private annuity and created a partial gift. In both instances, the trust assets were limited to an amount sufficient to meet the annuity promise payments, if the annuitant did not outlive his or her actuarial life expectancy. If the annuitant did outlive his or her life expectancy, there were insufficient assets to continue the annuity payments. The Service ruled that the agreement called for payments over the annuitant's lifetime or the actuarial life expectancy, whichever was less. Therefore, the annuity promise was devalued and a partial gift imputed.

Great risks attend the transfer of property for a private annuity issued by a foreign-situs trust. This type of transfer occurred fairly frequently prior to the Tax Reform Act of 1976,[66] because the trust was exempt from most United States taxation and, therefore, could accumulate corpus at a much faster rate than could a domestic trust.[67] If a citizen or resident of the United States sells an asset to a foreign trust in exchange for a private annuity today, however, the United States citizen or resident is subject to a nondeductible thirty-five percent excise tax on any unrealized appreciation in the value of the annuity property.[68] Furthermore, if a United States citizen or resident transfers property to a foreign trust for a private annuity promise and the trust has a beneficiary who is a United States citizen or resi-

65. Rev. Rul. 79-94, 1979-1 C.B. 296; Rev. Rul. 77-454, 1977-2 C.B. 351.

66. Pub. L. No. 94-455, 90 Stat. 1520 (1976).

67. I.R.C. § 871. The trust was exempt from most United States taxation because it was a foreign "person" and, therefore, taxed only on its United States source income. Since the foreign trust did not have any income generated from United States sources, it was not subject to United States taxation. *See generally* Zaritsky, *Foreign Trusts* (Tax Management Portfolio No. 416, 1980); Zaritsky, *Special Trusts and Unique Problems: Grantor Trusts after the Grantor's Death, Alimony Trusts, and Foreign Trusts Versus Domestic Trusts,* in 2 N.Y.U. THIRTY-SEVENTH ANNUAL INSTITUTE ON FEDERAL TAXATION § 42 (N. Liakas ed. 1979).

68. I.R.C. § 1491. *See* Alpert & Feingold, *Tax Reform Act Toughens Foreign Transfer Provisions of 1491 and Liberalizes 367,* 46 J. TAX. 2 (1977); Black, *Foreign Trusts and the Tax Reform Act of 1976: Taxation of Transfers and Beneficiaries,* 1977-22 TAX MANAGEMENT (BNA) 3 (1977); Caldwell & Nagel, *Foreign Situs Trusts,* 6 DEN. J. INT'L L. & POL. 675 (1977); Wyckoff, *U.S. Taxation of Foreign Trusts and U.S. and Non-U.S. Trust Grantors,* U.S. TAX. INT'L OPERATIONS (P-H) ¶ 6013 (1979); Zaritsky, *Special Trusts and Unique Problems: Grantor Trusts after the Grantor's Death, Alimony Trusts, and Foreign Trusts Versus Domestic Trusts,* in 2 N.Y.U. THIRTY-SEVENTH ANNUAL INSTITUTE ON FEDERAL TAXATION § 42 (N. Liakas ed. 1979).

dent, the trust is treated as a grantor trust, and the United States grantor is taxed on the trust's income directly, regardless of the trust's terms.[69]

V. DISADVANTAGES OF THE PRIVATE ANNUITY IN ESTATE PLANNING

Private annuities certainly have a place in estate planning, but they can create numerous problems and risks. If the annuity property does not generate its own income, the private annuity can cause severe cash flow problems for the obligor, since the obligor must raise elsewhere the cash required to make the annuity payments. On the other hand, if the annuity property generates the income used to pay the annuity, both the annuitant and the obligor are taxed on the income: the obligor is taxed because he owns the asset generating the income without the ability to deduct any of the annuity payments, and the annuitant is taxed on the annuity payments received from the obligor. One mitigating factor is the increase in the obligor's basis in the annuity property for depreciation purposes; if the property is depreciable, additional tax shelter is provided.

The actual length of the annuitant's life also can create problems for the obligor. If the annuitant outlives his or her actuarial life expectancy, the obligor will "overpay" for the annuity property. If the annuitant does not live as long as his or her actuarial life expectancy, the obligor receives the property at a bargain price, but with a very low basis for purposes of future sales and depreciation.[70]

One of the greatest pitfalls of the private annuity is the annuitant's risk of loss. Clearly, from decisions of the Tax Court, the private annuity must be an unsecured promise to pay, or the transaction is treated as closed; the annuitant, then, is taxed immediately on the excess of the present value of the annuity promise over his adjusted basis in the annuity property.[71] A sub-

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69. I.R.C. § 679(b). *See* Black, *supra* note 68. Zaritsky, *Special Trusts and Unique Problems: Grantor Trusts after the Grantor's Death, Alimony Trusts, and Foreign Trusts Versus Domestic Trusts*, in 2 N.Y.U. THIRTY-SEVENTH ANNUAL INSTITUTE ON FEDERAL TAXATION § 42 (N. Liakas ed. 1979).

70. *See* Rev. Rul. 55-119, 1955-1 C.B. 352.

71. *See* 212 Corp. v. Commissioner, 70 T.C. 788 (1978); Estate of Bell v. Commissioner, 60 T.C. 469 (1973).

stantial risk exists, therefore, that the obligor may waste the annuity property and be unable to continue making the annuity payments. This problem is complicated further by the annuitant's inability to retain control over the annuity property without having the value of the property included in the annuitant's gross estate under Code sections 2036 and 2038.

These risks are even greater if the obligor predeceases the annuitant, since the annuitant will be merely an unsecured creditor of the obligor's estate.[72] The estate may, however, be required to set aside sufficient assets, if existing, to fund future annuity payments or to pay the annuitant the present value of the annuity promise.[73]

VI. THE SPLIT-PURCHASE: A PRIVATE ANNUITY ALTERNATIVE

The private annuity clearly is a useful estate-planning device under the proper circumstances.[74] Its utility is subject to

72. If the annuity is secured, the annuity is treated as a closed transaction and the full amount of the annuitant's gain must be recognized in the year of the sale. 212 Corp. v. Commissioner, 70 T.C. 788 (1978); Estate of Bell v. Commissioner, 60 T.C. 469 (1973). *See* Hodges & Panarisi, *Planning Private Annuities,* 4 REV. TAX. INDIVIDUALS 214, 225-26 (1980). This risk may be reduced, however, by the use of a decreasing term life insurance policy on the obligor's life. Such insurance does not appear to be security for the annuity promise in the *Bell-212 Corporation* sense. *See* S. LEIMBERG & L. HODGES, THE PUBLIC LIFE OF A PRIVATE ANNUITY 63-65 (1980).

73. *See* Dabney v. Dabney, 54 Cal. App. 2d 695, 129 P.2d 470 (1942); *In re* Estate of Kennington, 204 So. 2d 444 (Miss. 1967); *In re* Guggenheim's Estate, 150 N.Y.S.2d 87 (Sur. Ct. 1955).

74. Perhaps the best way of illustrating the situation in which a private annuity produces the greatest estate-planning benefit is by describing the "perfect" annuitant, annuity property, and obligor. This description assumes that a goal of the private annuity is to transfer an asset and its future appreciation from the annuitant's gross estate to the estate of a close relation at the lowest possible tax cost. It also assumes that the annuitant wishes a stable, safe return on the transferred annuity property.

The "perfect" annuitant is in generally poor health, but is not terminally ill. The annuitant's actual life expectancy should be substantially shorter than his or her actuarial life expectancy, but not so short that the Service can deny the use of the actuarial tables. The Service will only deny use of the actuarial tables if "it is known on the valuation date that a life tenant is afflicted with a fatal and incurable disease in its advanced stages, and that he cannot survive for more than a brief period of time." Rev. Rul. 66-307, 1966-2 C.B. 429. *See* Estate of Lion v. Commissioner, 438 F.2d 56 (4th Cir.), *cert. denied,* 404 U.S. 870 (1971); Estate of Butler v. Commissioner, 18 T.C. 914 (1952) (Acq. 1953-1 C.B. 3). *But see* Continental Ill. Nat'l Bank & Trust Co. v. United States, 504 F.2d 586 (7th Cir. 1974). An actual life expectancy shorter than the actuarial life expectancy results in a transfer of the annuity property to the obligor at a very low income tax

certain limitations, particularly if the annuitant is in a high income tax bracket, if the annuity property generates fully taxable income, or if the annuitant cannot trust the obligor not to waste the source of annuity payments. The objectives of the private annuity, that is, to reduce the size of a client's taxable estate, to improve estate liquidity, and to insure continued income, may be accomplished by an interesting device known as a split-purchase. In a split-purchase, two individuals (typically parent and child) pool their resources to purchase a single asset, with the older and usually more wealthy individual purchasing a life estate in the asset and the younger individual purchasing the remainder interest.

The results of a split-purchase occasionally can be spectacular. The parent receives the income from the property (assuming it is income-producing in nature) but no portion of the corpus of the asset is included in the parent's gross estate because the parent owns only a life estate. Assuming that the relative purchase prices of the life estate and the remainder were determined from the actuarial tables,[75] which presume a six percent return, the child, while currently receiving none of the income, obtains an appreciation rate of six percent on the investment. The child's return can be increased substantially if the parent's actual life expectancy is not as great as his actuarial life expectancy under the tables. Unless the parent suffers from a terminal illness in its later stages, usually resulting in death within one year, the Service follows its actuarial tables in valuing the life interest.[76]

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cost and no gift or estate tax costs—one of the estate-planning objectives noted above. The "perfect" annuitant is also in a relatively low, marginal income tax bracket because the annuity will almost certainly generate a significant additional income tax liability for the annuitant.

The "perfect" annuity property is an asset that generates income. A lack of income imposes a substantial cash flow burden on the obligor, who must find other ways of paying the annuity amount. The asset should also generate either tax-exempt income, such as state or local bonds, or tax-sheltered income, such as income-producing real estate. Generation of this type of income relieves the obligor of the substantial income tax burdens that may otherwise attach to a private annuity.

The "perfect" obligor is highly solvent or, at least, skilled in the management of the annuity property. This solvency lends greater security to the annuitant's income flow, since it either assures assets against which the annuitant may seek payment of the annuity or decreases the likelihood that the annuity property will be wasted.

75. Treas. Reg. § 20.2031-10(f) (1970).

76. Rev. Rul. 80-80, 1980-12 I.R.B. 10; Rev. Rul. 66-307, 1966-2 C.B. 429. *See* Estate of Lion v. Commissioner, 438 F.2d 56 (4th Cir.) *cert. denied,* 404 U.S. 870 (1971); Estate

Therefore, if the parent's health is poor, but the parent is not terminally ill, the parent's payment constitutes a sum greater than the real value of the life estate, and the child actually receives a portion of the value of the property without paying a fair consideration or imposing a gift tax on the parent.

An additional benefit of the split-purchase is the amortization of the parent's life estate if the asset generates income.[77] Even if the asset, such as a corporate bond, does not normally generate tax-sheltered income, the amortization deductions permit the parent to receive the income at least partially tax-free. For example, if a fifty-five-year-old mother purchases a life estate in a $100,000 corporate bond, which pays ten percent interest per annum, her portion of the purchase price is $69,859.[78] Her actuarial life expectancy is 25.5 years[79] and her annual amortization deduction (and tax shelter) is $2,739.57. Additionally, the holder of a life estate need not worry about the security of his or her investment; the holder of the remainder interest is not in a position to squander any portion of the corpus from which the income will be paid.

VI. Conclusion

The private annuity is an estate planner's tool and it serves many useful estate-planning purposes, which include reducing the annuitant's taxable estate, improving the annuitant's liquidity, and providing a future source of income. Careful selection of the appropriate annuitant, obligor, and annuity property is essential to achieve these purposes. The private annuity, however, is not for every client. In some situations a split-purchase might serve a particular client's interests better than a private annuity. It is important for every estate planner to be familiar with both the private annuity and the split-purchase and to consider with

of Butler v. Commissioner, 18 T.C. 914 (1952) (Acq. 1953-1 C.B. 3). *But see* Continental Ill. Nat'l Bank & Trust Co. v. United States, 504 F.2d 586 (7th Cir. 1974).

77. *See* Manufacturers Hanover Trust Co. v. Commissioner, 53 T.C. 114 (1969), *aff'd,* 431 F.2d 664 (2d Cir. 1970); Hrobon v. Commissioner, 41 T.C. 476 (1964). *See generally* Sohosky v. Commissioner, 57 T.C. 403 (1972), *aff'd,* 473 F.2d 810 (8th Cir. 1973). *But see* Early v. Commissioner, 52 T.C. 560 (1969), *rev'd,* 445 F.2d 166 (5th Cir. 1971).

78. Treas. Reg. § 20.2031-10(f), Table A(2) (1970).

79. Treas. Reg. § 1.72-9, Table I (1956).

caution the appropriate use of each in the estate-planning process.