

The Public Life of the Private Annuity

F. Bentley Mooney, Jr.

Until October 18, 2006, the real estate industry was buzzing about the traditional private annuity as an exit plan from an overheated market, one that secures important tax avoidance and deferral benefits. Then IRS threw a monkey wrench into the works with a proposed treasury regulation. That regulation is discussed in the next segment of this syllabus.

The private annuity as a financial planning tool surfaced periodically over the past century or so. Its usefulness fluctuated with income tax and interest rates, the former imposed on the person or entity *paying* the annuity, and the latter set by the *Internal Revenue Code of 1986*, as amended (Code), for use in calculating the benefit. For the past several years, both tax and interest rates are below historic levels, leading to reexamination of this well-established planning tool.

The principal benefits of a private annuity include: (1) removing assets from the gross estate of the annuitant for federal estate tax purposes, without the gift tax as a toll charge; (2) retaining an income; (3) spreading recognition of capital gain and recapture taxes over the annuitant's life expectancy when exchanging appreciated property for the annuity; and (4) delivering the appreciated property to the payor with a new tax basis. The new basis permitted immediate sale of the exchange property by the payor without capital gain taxation.

Here, we will examine the private annuity and take a close look at its use in a variety of circumstances. Private annuities, if used artfully, may be the most powerful weapon available today for postponing income taxes, avoiding wealth transfer taxes, obtaining relief from management and investment worries, and preserving a source of income. Postponing capital gain taxation, however, is subject to the outcome of the proposed regulation.

A private annuity is an agreement between two parties, neither of whom (or which) is in the business of issuing annuities. Under the agreement, the annuitant transfers property to the payor in exchange for the payor's promise (usually unsecured) to make periodic payments in specific amounts to the annuitant, typically for life: (*e.g.*, father gives son the family farm in exchange for son's promise to pay father \$1,000 per month for life). *The tax objectives are gained whether or not the annuitant lives out his or her life expectancy.*

Here are the defining characteristics of the private annuity:

- It establishes the annuitant as a general creditor of the payor.
- The parties are usually individuals who are related to each other, although artificial entities are permitted.
- Private annuities may be arranged between a corporation and an individual, a trust and an individual, or between an estate and a corporation (with the estate exchanging property for payments by the corporation measured by the life of an individual). Annuities may also be between a corporation and a retiring shareholder under a stock redemption arrangement.
- The payor cannot be a person who is engaged in the business of issuing annuity contracts, even occasionally. (*Rev. Rul. 55-119, 1955-1 CB 352, (Jan. 1, 1955)*) If so, the difference between the present value of the annuity on the date of exchange (set by treasury regulations) and the annuitant's basis in the

property is immediately recognized as a capital gain, recapture tax, or both. (*Rev. Rul.* 62-136, 1962-2 CB 12) The present value of a private annuity is determined under the IRS tables for valuing limited interests. (*Rev. Rul.* 62-137, 1962-2 CB 28) These tables appear in *Treasury Regulations* 20.2031-10(f) and 25.2512-9(f). Again, whether this tax deferral survives depends on the outcome of the proposed regulation noted above.

- As soon as the agreement is signed, the payor becomes the legal owner of the exchange property, and may sell or otherwise dispose of it as desired. The annuitant could retain an interest in the property to secure the annuity obligation, but doing so leads to recognition of any gain on the exchange. (*Estate of Bell*, 60 T.C. 469 (1973)) This is not an issue, of course, when the exchange property is cash or a high-basis capital asset.

- The annuity payments must be in the nature of an annuity -- the systematic liquidation of principal and interest over a specified period of time. For the most desirable estate tax results, the annuity should continue for the annuitant's lifetime, no matter how long, but not one day more. This, of course, has an economic impact on the annuitant and payor quite apart from tax considerations. The annuity installments are ordinarily level for life, but may be inflation-adjusted so long as the present value at the date of exchange is the same (that is, if gift tax avoidance is desired). The annuity may also be deferred, with the annuity payments to begin at some future date.

As to the inflation-adjusted variety, the annuitant selects the percentage based on a best estimate. The first-year amount of the annuity is usually 70% to 80% of the level payment, depending the age of the annuitant, and each subsequent year is increased year-over-year by the selected percentage. Payments in the early years are usually low enough to add substantially to the exchange property reserve in the hands of the payor, to be used in the later years as payments rise over time. Only an actuary is able to calculate present values for future annuity payments (by which to test the math for accuracy), so we rely on the software and hand calculations for the starting point and annual adjustments. What makes present value calculations complicated is that to reach the correct figure, you must calculate the probability of each payment being made, using *Mortality Table 90CM* (regulations under Code Section 7520). The difference is sometimes subtle, but with an increasing annuity, future payments can be quite large. The payments that "might" be received if the annuitant survives to normal life expectancy can be significant. Consequently, a calculation of the present value of the payments for a fixed term equal to normal life expectancy would not be the same as an actuarial calculation of the value of the payments for life. Not that you really wanted to know all that.

A private annuity should not be confused with a life estate. It provides a predetermined income lasting for the lifetime of the annuitant, whereas a life estate does not guarantee income, and pays only as much income as the supporting principal earns. With a life estate, the annuitant transfers the property but retains an income interest in it. This is not the case with a properly arranged private annuity. IRS has argued that the purchase of a private annuity constitutes a transfer with a retained interest such as will cause the property to be brought back into the gross estate of the annuitant under Code Section 2036(a), as if it were a life estate. The courts, however, have firmly rejected that contention, based on the character of the private annuity transaction as a purchase and sale at fair market value. (*Stern v. Commissioner*, 650 F. Supp 16 (1986); see also *Estate of Fabric vs. Commissioner*, 83 TC 932, 935 (1984))

Here is a model private annuity agreement for married annuitants.

Private Annuity Agreement

THIS PRIVATE ANNUITY AGREEMENT ("Agreement") is made and entered into in duplicate

original this day of [] by and between [] and [] (variously "Husband" and "Wife," or jointly, "Annuitants") and [] ("Payor").

THIS AGREEMENT is made with reference to the following facts:

(a) Husband was born [], and on the date of this Agreement he is [] years of age. Wife was born [], and on the date of this Agreement she is [] years of age.

[IF PROPERTY IS EXCHANGED]

(b) Annuitants are the owners of certain property described at *Exhibit A*, attached to and incorporated into this Agreement by reference (the "Property").

(c) Annuitants desire to be relieved of the duties of management required by the Property, and to be assured a fixed annual income for life, regardless of the income-producing capacity of the Property.

(d) The fair market value of the Property, is \$[].

(e) Annuitants' tax basis in the Property is \$[].

(f) Payor desires to acquire the Property as an investment in exchange for fixed annual payments to Annuitants and the survivor for life, which payments have a present value of \$[].

[IF BOUGHT FOR CASH]

(b) The parties desire to enter into an exchange of cash for a private annuity on the terms set forth herein.

[CONTINUE]

NOW, THEREFORE, in consideration of the recitals, covenants, promises and conditions here contained, the parties agree as follows:

1. **Consideration.** The consideration for the promise of Payor is as follows:

A. Concurrently with the execution of this Agreement, Annuitants shall sell, transfer, assign and convey the Property to Payor, in legally sufficient form.

B. Annuitants shall advance and pay all costs incurred in connection with that delivery, including the costs of preparing any instruments of transfer. Payor may reimburse Annuitants costs so advanced, for costs of trust administration advanced to the sole shareholder of Payor, [] **Limited** (Trustee, *The [] Trust*, and for [legal fees, financial planning, accounting, appraisals, sales commissions and] costs connected with establishing the said trust and Payor as a corporate entity.

2. **Annuity Payments.** The annuity payments by Payor shall be made as follows:

[LEVEL PAYMENT ANNUITY]

A. Payor, for itself, its successor and assigns, shall pay to Annuitants, the sum of US\$[] per annum, payable at the end of each said period, for the remainder of the life of Annuitants and that of the survivor, commencing 365 days following the date hereof. Payments shall continue on the same day of each calendar year thereafter unless changed to a more frequent mode with an adjustment for the time value of money as determined under U.S. *Internal Revenue Code*,

Section 7520.

[ALTERNATE, INFLATION-ADJUSTED ANNUITY]

A. Payor, for itself, its successor and assigns, shall pay to Annuitants, the sum of US\$[] per annum, payable at the end of each said period and increased annually after the first said payment period for their joint life expectancy of [] years in a sum equal to []% of the previous year's payment. The schedule of payments is attached, designated *Exhibit B* and incorporated herein by this reference. If one or both Annuitants survive their joint life expectancy, the payments thereafter shall be \$[] per year for the remainder of the actual life of Annuitants and that of the survivor. Payments shall commence 365 days following the date hereof and shall continue on the same day of each calendar year thereafter unless changed to a more frequent mode with an adjustment for the time value of money as determined under U.S. *Internal Revenue Code*, Section 7520.

[CONTINUE]

B. The annuity payments shall be made directly to the Annuitants or the survivor, but in the event of the disability or incapacity of both or the survivor, Payor may make the required payments to the trustee or successor trustee of *The [] [Year] Trust*, domiciled in the State of []. If any payments are so applied, Payor shall, within a reasonable time thereafter, notify Annuitants or the survivor, or the legal representative of either or both, in writing, of the amounts so paid.

C. The obligation to make annuity payments shall cease and terminate at the death of the surviving Annuitant, irrespective of the number of payments made and whether or not any payments were made; provided, however, that nothing in this provision shall be construed as avoiding the obligation to make payments accrued and unpaid on the date of the surviving Annuitants's death, *pro rated* to said date.

3. **Promise to Pay Unrelated to the Property.** The payments described at paragraph 2 above are to be made without reference to the Property and irrespective of any income produced by it. The payments are the obligation of Payor and are not limited in any way to the value of the Property.

4. **Free Alienation.** Payor may freely sell, assign, convey or pledge the Property, free and clear of all claims whatsoever by Annuitants, or either of them. The obligation to make payments to Annuitants continues without regard to any such sale, assignment, conveyance or pledge. It is agreed and understood by the parties that the payments to be made to Annuitants under this Agreement are not secured in any manner by the Property or otherwise.

5. **Binding Effect.** This Agreement shall inure to the benefit of and shall be binding on the heirs, assigns, successors in interest and legal representatives of the parties. No heir, legatee, creditor or beneficiary of the estate of Annuitants, or either of them, nor the estate itself, shall have any rights in this Agreement. The interest of Annuitants shall not be assigned, nor shall it be anticipated, hypothecated or sold.

6. **Choice of Law.** This Agreement is made in the State of California and shall be in all manner construed and enforced in accord with the laws of that state.

7. **Entire Agreement.** This Agreement represents the entire agreement of the parties and supersedes any prior written or oral agreements between them pertaining to the subject matter of

this Agreement.

IN WITNESS WHEREOF, the parties have executed this Agreement the day and year first above written.

[Signatures]

The private annuity may be useful in a wide variety of life circumstances.

- The private annuity may be used as a “last chance retirement fund.” If the annuitant never prepared for retirement, a private annuity may provide economic security in a variety of ways. For example, exchange an interest in the annuitant’s house, sell, and purchase a less expensive home near the kids, retiring with no mortgage and a tidy annuity income to supplement the Social Security retirement benefit. Same for the store building the annuitant bought 30 years ago, or the office building bought during his third year of practice, or a seldom-used second home.
- The annuity may be used to create a market for an otherwise unmarketable business.
- Avoiding gift and estate taxes is always a popular use for a private annuity. Taxable gifts – even those employing complex and expensive discounting techniques – will use up all or part of the annuitant’s applicable exclusion amount, increasing the tax payable on death. The use of a private annuity, however, accomplishes substantially the same end, without characterization as a gift, and therefore without use of the applicable exclusion amount.
- Shifting appreciation to the next generation is another attraction. When a business venture shows promise of substantial and continued growth, the annuitant may wish to exchange it with the children for a life annuity. This removes it from his gross estate, replacing it with annuity income of equal value, adjusting basis to fair market value in the hands of the children as Payors. This effectively shifts the post-exchange appreciation to the next generation. Congress attempted in 1990 to eliminate such appreciation-shifting techniques by enacting Chapter 14 of the *Code* at Section 2036(c). The techniques addressed at Chapter 14, however, are *gift* arrangements requiring retention of an interest in the gift property. The private annuity is a *sale*. If made at fair market value, the undesirable effects of Chapter 14 are avoided.
- Trading capital for income is another use. The annuitant may own property producing little or no income (*e.g.*, unimproved or agricultural property). Just as often, that property has appreciated substantially. Rather than keep it for delivery to the children at the stepped-up basis acquired at death (Code Section 1014), along with a federal estate tax, the annuitant may convey it to the children in exchange for a private annuity. The children get it with the current fair market value as their tax basis, allowing them to sell it without capital gain taxes and to redeploy the proceeds into income-producing investments. The annuitant thereby avoids a potential estate tax burden, and gains a life income.
- Because of the dramatic results in terms of eliminating gift and estate taxes on the property exchanged for the annuity, the deathbed purchase leaps immediately to the fertile mind. As you might imagine, IRS takes a dim view of this type of estate tax avoidance. In *Revenue Ruling 80-80* (1980-1 CB 194), it established a rule that the annuity is to be disregarded if death is imminent, thereby taking away the tax benefits of a transaction conforming to all legal requirements. In attacking transactions involving seriously ill annuitants, IRS asserted that the payments were never intended. The United States Tax Court, however, was more generous. In *Estate of Fabric* (*ibid*, page 3) the annuitant was scheduled for open heart surgery at the time the annuity was established. She survived the surgery by one year, five months. In affirming the

legitimacy of the transaction, the Court stated the following:

At the time of decedent's execution of the annuity agreement, it was not established that her maximum life expectancy was one year or less. In addition, while the decedent underwent open heart surgery five days later, she survived the operation by one year and five months. Furthermore, the uncontroverted testimony of decedent's physician was that as of late 1975, decedent should live several more years, possibly even five more years The evidence demonstrates that the decedent's death was not clearly imminent or predictable at the time she entered into the annuity agreement. Only where death is imminent or predictable will departure from the tables be justified.

In *Estate of McDowell* (TC Memo 1986-27 (1986)) the transaction was respected because, although the annuitant's death was imminent, his life could be prolonged by treatment.

The regulations now provide more of a bright line test: if there is a 50% probability of death within a year, the annuitant is considered terminally ill for these purposes. However, if the annuitant survives for 18 months after purchasing the annuity, he or she is rebuttably presumed *not* to be terminally ill. (*Treas. Reg* 25.7520-3(b)(3))

- To some extent the creditor protection afforded by the private annuity is derived from available state exemptions, but to a greater extent it arises from the nature of the device. The exemptions may protect the income, and even accumulated annuity income. As to the nature of the device, the private annuity is a contractual right to a stream of income, so the creditor may reach – at best – the installments as they are paid, one at a time. This makes it unattractive to the creditor, and may deter that creditor from spending collection resources on the chase.

If the annuitant winds up in a bankruptcy proceeding, the trustee in bankruptcy will consider whether the private annuity is an “executory contract.” (An executory contract may be rejected and the consideration brought back into the bankruptcy estate.) The answer turns on the definition of that term. To be “executory,” there must be some “substantial performance” due from both parties to the agreement (*In Re Murexco Petroleum*, 15 F3d 60, 62 (5th Cir 1994)) After the annuitant has paid for the annuity, the duties are no longer mutual; *i.e.*, only the payor owes a duty, so the contract is no longer executory. Therefore, the contract may not be rejected by the bankruptcy trustee as a means of recovering the consideration paid, leaving that trustee only the power to claim the periodic annuity installments.

Income Taxes. The income tax treatment of a private annuity varies, depending on the facts and circumstances. The investment in the annuity for purposes of computing the income tax exclusion ratio is the annuitant’s tax basis in the exchange property. If the exchange property is classified for income tax purposes as a capital asset (*e.g.*, a commercial building), and if it has appreciated in value, then the annuitant will realize a capital gain on the exchange, and perhaps recapture tax, in an amount equal to the difference between basis and the present value of the annuity. But, if the promise to pay is unsecured, the exchange is classified as an open transaction, with capital gain and any recapture recognized ratably over the annuitant’s life expectancy. (*Burnet v. Logan*, 283 U.S. 404 (1931); *Lloyd v. Commissioner*, 33 BTA 903 (1936); *Estate of Bell v. Commissioner*, 60 TC 469) Therefore, each annuity installment is allocated partly to basis (recovered tax-free), capital gain (taxed at the preferred rate if long term) and ordinary income (taxed at ordinary income tax rates). This enables the annuitant to recognize gain in the same way as the return of basis. Ordinary income may include recapture tax. If the annuity is a life annuity and the annuitant survives beyond life expectancy, the capital gain portion of the annuity becomes taxable as ordinary income. The portion allocated to recovery of basis, however, is tax-free for life. (*Rev Rul* 69-74, 1969-1 CB 43)

If the obligation to pay the annuity is secured, the full gain is recognized in the year exchanged for the private annuity. (*Lloyd vs Commissioner*, *ibid.*; *Estate of Bell*, *ibid.*) This matters not if the exchange property is cash, but since most involve the exchange of appreciated property, secured private annuities are rare.

When total annuity payments equal the original value of the exchange property, less depreciation deductions, each subsequent annuity payment is a deductible loss to the Payor. If the Payor *sells* the exchange property, then the annuitant dies after the sale and before the expiration of his life expectancy, (a) the payor's basis in the former exchange property is adjusted to the sum of all annuity payments to the date of death, (b) any gain is recalculated, and (c) the Payor must recognize the additional gain arising from the reduced basis.

If the Payor *keeps* the exchange property, and if the annuitant dies before the expiration of his life expectancy, the Payor receives a basis adjustment, reducing it to a sum equal to the total annuity payments paid.

Aside from the premature death circumstance, saying that the payor's basis is "equal to fair market value on the date of exchange" is correct, but not quite that simple. Basis in the hands of the Payor is a sum equal to the total annuity installments paid, plus the then-present value of the remaining payments, plus capital improvements, less depreciation. If the present value of the annuity on the date of exchange is equal to the value of the exchange property, those two figures always add up to the same number, changing only at the annuitant's death.

For example, if his life expectancy on the date of exchange is 12.5 years (male life expectancy at age 75 under *Reg 1.72-9*, Table V), and the annual installments are \$14,042, and if the Payor sells the exchange property immediately after the transaction date, basis for computing gain is \$175,525 ($\$14,042 \times 12.5$).

To extend the example, if the property is depreciable, such as an apartment building, and if payments were made for 10 years, at which time it is sold for \$280,000, the calculations would set up like this:

Payments made to date of sales ($\$14,042 \times 10$)	\$140,420			
Present value of remaining payments ($2.5 \times \$14,042$)	<u>35,105</u>			
		Payor's Basis		\$175,525
			\$175,525	
Less straight-line depreciation			<u>-40,000</u>	
<u>-40,000</u>				
Capital gain taxes are payable on ($\$280,000 - \$175,525 + \$40,000$).	\$144,475			

With the basis adjustment comes recognition of income or loss by the Payor, maybe. (*Rev Rul 55-119*, 1955-1 CB 352) If the exchange property was sold for more than its basis and prior to the death of the annuitant, the difference between the adjusted basis and the net sale price must be recognized by the Payor in that year's income tax returns. This also has its effect on recapture of depreciation based on the prior -- higher -- basis.

For purposes of determining loss, the payor's basis in the exchange property is equal to the sum of all annuity payments made through the date the property is sold. If the exchange property is sold for more than

the loss basis (payments made) but less than gain basis (payments made plus the present value of future payments), no gain or loss is recognized. If the annuity becomes worthless (the Payor is insolvent), the annuitant may deduct the remaining value (price paid less the value of annuity installments received) as a capital loss. (*McIngvale v. Commissioner*, 936 F.2d 833, 939 (5th Cir. 1991))

Basis is affected by the existence of a gift interest in a private annuity. Specifically, a tax may be incurred if the fair market value of the exchange property exceeds the present value of the annuity. The excess is the amount treated as a gift. If the value of the annuity exceeds the fair market value of the property exchanged, the Payor is deemed to make a gift to the payor with every annuity payment.

For example, assume the annuitants are age 65, and transfer \$100,000 to their child in exchange for a private annuity. The annuity factor is found in IRS Publication 1457, *Actuarial Values-Alpha Volume*; it is 7.1213, assuming an interest rate of 10% under Code Section 7520 (Table S (10.0)). The annual annuity payments should be \$14,042. Therefore, if the annuity payments are less, the difference is a gift from the annuitant to the payor.

Another example, if the annual annuity payments are set at \$12,000 instead of \$14,042, the gift is \$14,542, calculated as $(\$14,042 - \$12,000) \times 7.1213$. The way to deal with it is to switch from a one-time gift of excess value to a full-value annuity payment level from which annual gifts falling within the gift tax annual exclusion amount may be made. (Code Section 2503(b))

If the exchange property is worth more than the annuity, the payor takes the basis of the annuitant in that excess portion, reducing overall basis in the payor's hands. This impacts both depreciation/amortization deductions available to the payor and gain on later sale.

See also the "exhaustion test" discussed at page 12 under *Federal Gift Tax*.

Interest may be imputed to certain debt instruments under the original issue discount rules. (Code Sections 1271-1275) They do not, however, apply to annuities -- including private annuities - if payment depends "in substantial part" on the life expectancy of one or more individuals. (*Treas. Reg 1.1275-1(j)*)

There are other income tax consequences for the payor. There is no deduction for payments made to the annuitant. (*Rev Rul 72-81, 1972-1 CB 98*) Rather, the annuity installments are deemed payments on the purchase price of the property. Also, if the property exchanged for the annuity is a wasting asset, the depreciation/amortization deductions are adjusted in accord with the basis adjustment in the hands of the payor discussed earlier. (Code Section 167(a)(2)) This is particularly important where the property was fully depreciated/amortized by the annuitant prior to the exchange; the payor gets to depreciate or amortize it all over again.

Federal Estate Tax. The private annuity removes the exchange property from the gross estate of the annuitant for estate tax purposes, substituting a stream of income. At his death the payments stop, leaving no remaining value to tax. If at death there is a surviving spouse and the annuity is structured to continue for the lifetime of that survivor (joint and survivor annuity), the marital deduction permits deferral of any estate tax on the value of the annuity payments remaining at the first death. (Code Section 2056) On death of the survivor, the annuity term expires, leaving no remaining value to tax.

It bears repeating that the obligation to make annuity payments does not attach to the property exchanged; it is personal to the payor. Thus, even if the property is sold after the exchange, the payor's obligation remains. The payor's estate receives an estate tax deduction in a like amount. If the payor dies before the annuitant, the annuity obligation continues as a claim against the payor's estate. The then-present value of the remaining annuity payments sets the amount of the estate tax deduction for that claim. (Code Section 2053(a)(3)) If on the other hand, the annuitant predeceases the payor, there is no remaining obligation, thus

no deduction. Of course, if the payor dies still owning the exchange property without respect to the timing of death between the two, the payor's estate receives a new basis equal to that used in reporting the federal estate tax. (Code Section 1014)

Federal Gift Tax. A federal gift tax may be imposed on the private annuity transaction if the values involved (value of the property versus value of the annuity) do not match. This consequence should be avoided unless part of a larger plan.

In the context of gift taxation, another consideration arises from an attempt by IRS to skew the result in a way the annuitant would not appreciate. It applies only when the Payor of the annuity is an irrevocable trust or estate. We may refer to it as the "exhaustion test." Under *Treasury Regulations* 1.7520-3(b)(1), 20.7520-3(b)(1) and (2), and 25.7520-3(b)(1)(2), if the annuity payout rate exceeds the interest rate imposed by IRS under Code Section 7520, the exchange property "may" become exhausted before the death of the annuitant. Therefore, the annuity rate must be recalculated on the assumption that the annuitant will survive to age 110. For a 60-year-old annuitant exchanging \$1.2 million for an annuity of \$97,224 per year for life, the value of the annuity increases from \$1.2 million to \$1,890,500 under the required recalculation. The result is that the annuitant must either make a reportable gift to the payor of the \$690,500 difference prior to the annuity exchange, or be *deemed* to have made a gift in that amount. Private annuities will never survive economic analysis if the exhaustion test is followed.

Fortunately, the exhaustion test exceeds the bounds of reason to such an extent that the courts have often refused to enforce it. The cases are inconsistent, but generally recognize three constitutional arguments:

- IRS is authorized by law only to issue annuity "tables" for the implementation of Code Section 7520. The exhaustion test is not a "table." Consequently, the test constitutes a regulation exceeding the express delegation from Congress.
- There is no support for the exhaustion test, either in the statutory language or in the legislative history of Section 7520. The regulations fall short of implementing IRS' authority in a reasonable manner. As such, they are an invalid extension of IRS authority.
- The regulations are patently arbitrary, capricious, and an abuse of discretion as a purportedly reasonable construction of Code Section 7520. To assume that anyone will live to age 110 defies life as we know it. This alone makes the regulations invalid as arbitrary (based on IRS preference) and capricious (fanciful).

In *Shapiro Estate vs. Commissioner*, 66 TCM 1067 (1993), the U.S. Tax Court rejected the IRS position that the taxpayer would live to age 109, noting that the prospect is extremely remote. In *Weller vs. Commissioner*, 38 TC 790 (1962), The U.S. Tax Court found that use of the Code Section 7520 annuity tables "... must be sustained unless it is shown that the result is so unrealistic and unreasonable that either some modification in the prescribed method should be made, or complete departure from the method should be taken, and a more reasonable and realistic means of determining value is available." In *O'Reilly vs.*

Commissioner, 973 F.2d 1403 (8th Cir. 1992), the U.S. Eighth Circuit Court of Appeals held that the tables must be used unless their use produces an unrealistic and unreasonable result. Inconsistent (but not a matter of concern) with all the foregoing is *Walton vs. Commissioner*, 115 TC 41 (2000) in which the U.S. Tax Court refused to engage in the debate because in that case the result would be the same under either model.

At bottom, the regulations are there for consideration. We may, however, ignore them in structuring a private annuity transaction unless a private letter ruling is needed for some esoteric twist to the arrangement. In that case, focus on the twist and leave the annuity calculations out of the request. For example, if the annuitant is an 80-year-old widower, we might seek a private letter ruling that the annuity will be recognized as a single

premium deferred annuity if the payor declares annual dividends payable to the trust/shareholder for ultimate distribution to the annuitant in a sum not exceeding excess interest earnings during the deferral period. This proposition may be couched without specific annuity calculations.

Federal Generation-Skipping Transfer Tax. The GST tax applies not only to trusts but to “trust equivalents.” (Code Section 2611(a)) Included among the latter are “insurance and annuity contracts.” (Code Section 2652(b)) That possibility notwithstanding, a private annuity leading to GST tax is rare.

Treasury Regulation 26.2611-1 provides as follows:

“A generation-skipping transfer (GST) is an event that is either a direct skip, a taxable distribution, or a taxable termination. See Section 26.2612-1 for the definition of these terms. *The determination as to whether an event is a generation-skipping transfer is made by reference to the most recent transfer subject to the estate or gift tax. See Section 26.2652-1(a) (2) for determining whether a transfer is subject to federal estate or gift tax.*” (Emphasis added.)

The import of *Treasury Regulation 26.2611-1* is that if there is no gift or estate tax, there is no GST tax. If there is no GST tax, the \$1 million GST tax exemption is irrelevant. The annuitant is not limited to the exemption amount in establishing a multi-generational trust. Rather, that trust may be established and funded for *any* amount if it is a result of the remaining value of property given in exchange for a private annuity. That eliminates the federal gift tax, estate tax, and GST tax.

Structuring Methods. There are several considerations in structuring the private annuity:

- When the annuitant is older, the life expectancy is shorter. Therefore, the annuity payments must be larger in order to distribute all principal over that shorter period of time. Our aim is to structure the transaction so that the expected rate of investment return exceeds the payout rate, thus avoiding principal invasions. For example:

The annuitant is 60, the exchange property is \$1 million, and the annuity is \$70,000 per year. If the payor earns only the interest rate mandated by IRS (presently, about 6%), the principal will be gone in 20 years. But if the payor earns a net return of \$80,000 (8%), no principal invasion will be required, and the \$1 million plus accumulated excess earnings will redound to the benefit of the family on death of the annuitant. Our task is to so order the transaction so as to produce precisely this result. It keeps the money in the family, and gives the annuitant a reasonable probability of avoiding funds exhaustion.

For another take on this need, consider that investment volatility may be friend or relentless foe. For half a century, financial advisors have urged investors to invest regularly, in substantially equal amounts, over extended time periods in order to “dollar average” the acquisition costs of their investments. The concept is that they purchase more investment units in down markets and fewer in high markets, leading to a lower average cost per share. The effect is just the reverse with respect to *distributions*. If the annuity payments require principal invasions, the payor may find it difficult to make a full recovery if, as, or when, the market recovers. Therefore, every private annuity obligation should be structured to reduce the risk that principal invasions will be required, thereby reducing the risk of outliving the money. If the transaction structure leads to exhaustion of the funds, the private annuity becomes an installment sale, with capital gain and recapture tax deferral. That is not a *bad* thing, but it leaves no payoff for the family on death of the annuitant.

- Annuity settlement options are the remedy of choice. They include annuity payments for the

annuitant's lifetime, for a specific period of time, for the lifetimes of two persons and the survivor, and for life with the refund of any principal remaining upon premature death paid to a named beneficiary. As noted above, the annuity installments may also be level or inflation-adjusted, immediate or deferred. To the extent a benefit is payable on death of the annuitant, that benefit constitutes an asset included in his gross estate for federal estate tax purposes. (Code Section 2039(b)) The highest payout rate is for a guaranteed minimum number of payments called a "life with period certain." The payout rate is reduced if the agreement provides for lifetime payments, and no longer. It is reduced more if paid for the longer of two lives (e.g., joint and survivor). For example, the payout rate for a single annuitant age 65 (mandated interest rate of 5.8%) is 10.13%, but for a couple, both age 65, it is 8.4%

- The annuitant should purchase the private annuity as soon as it makes economic sense: annuity installments are lower where the life expectancy is longer, bringing the obligation more within the likely investment return on the property exchanged. A benefit by serendipity is that it also spreads the capital gain and recapture tax (if any) over more years.
- An inflation-adjusted annuity lowers the installments in the early years. The only law recognizing a private annuity with this feature is a private letter ruling (PLR 9009064), but it serves to convey the IRS' view for our purposes. Reduced installments in the early years may allow the payor to build up an accumulated income reserve, thereby reducing the prospect of funds exhaustion in later years. For example, the 65-year-old couple above would receive a payout rate of 8.4% per year under a level-payment annuity, but under a 3% inflation-adjusted annuity, it would begin at 6.4% and increase annually throughout their joint life expectancy.
- If the selection of the payment option does not bring the payout rate within available income from the exchange property or its sale proceeds, the annuitant may consider first gifting 1% to the children, then placing the property in a limited partnership. He allocates the retained 99% to the limited interest, and exchange that interest for the annuity. Backed by an opinion by an independent valuation firm, the annuitant takes a valuation reduction of 15% to 40% for lack of marketability and lack of control. By reducing the value of the interest exchanged for the annuity, the required payout rate is reduced. Two cautions: (a) in California, be certain to convey the 1% interest in the properties to the children *before* conveying the 99% to the partnership in order to avoid loss of the parent-child exclusion for property tax reassessment; and (b) the annuitant should retain no personal use of the conveyed properties (otherwise, the property value will be brought back into his estate for federal estate tax purposes under Code Section 2036(a)).

All or part of the exchange property may be sold by the payor, who may then invest the proceeds in higher-yield investments. Given the reduced fair market value basis of the payor following the limited partnership exchange, the post-exchange sale will result in a reportable gain by the Payor.

- On the right facts, it may prove attractive to set the annuity installments at full exchange-date value with no gift imputed, but return part of each annuity payment as a gift to the payor. This enables the annuitant to make use of the annual gift tax exclusion. This also allows the annuitant to judge each year how much is needed for living expenses, permitting adjustments the gift amounts accordingly.
- Borrowing on the security of the property may help. The payor could borrow money using the exchange property for collateral in order to raise cash from which to pay the annuity installments, or in order to redeploy the proceeds into higher-yielding investments. If that would lead to negative cash flow, a reduced annuity payment by encumbering the property in advance of the exchange could lead to a workable result. If the loan is greater than the annuitant's basis at the time of the exchange, it may, or may not -- depending on the facts -- cause recognition of the gain on transfer.

- If the private annuity agreement is with all of the children (rather than one), the shared payment burden may be easier to bear.

Trust as Payor. If the private annuity is structured using an irrevocable gift trust (for the children) as Payor, special caution must be used:

- The trust should *not* be drafted to cause the annuitant to be the “deemed owner” of the trust for income tax purposes (a “defective grantor trust”). A principal income tax benefit of the private annuity would be lost: the payor would not acquire a fair market value basis in the exchange property (thus no tax-free resale), and tax allocations of the annuity installments under Code Section 72 are denied.
- Code Section 72(u) treats the surrender value of a *deferred* annuity, less the exchange property value, as ordinary income to the annuitant on surrender. It does not address the question of a private annuity with no surrender value. If the contract is for a single premium *immediate* annuity, the annuity tax rules apply. (Code Section 72(u)(3)(E)) The trust will report all its income, deductions, and credits. The trust acquires what amounts to a fair market value basis in the exchange property useable to avoid any capital gain tax on its subsequent sale. The annuitant reports gain and ordinary income on the annuity installments (but not the tax-free ratable recovery of basis) under the annuity rules of Code Section 72.

Unlike installment sales under Code Section 453, the rules on resale by a related party are inapplicable. Under *GCM 39503*, IRS puts it this way:

“The related party resale rules outlined above are inapplicable to private annuity transactions. Thus the transferee in a private annuity situation could quickly dispose of the property, and no accelerated recognition of gain would be charged to the original seller/transferor.”

Addition of a cash surrender value creates a valuation problem. Code Section 1275 deals with original issue discount rules. (OID) If OID applies, it creates a shortfall between the *issue price* of a debt instrument and its *stated redemption price* at maturity. This, in turn, skews our aim of matching the exchange property value to the present value of the annuity, thereby avoiding gift tax exposure. An exception to the OID rules is made for annuities measured by one or more lifetimes. The exception does not apply where the annuity has – directly or indirectly – a cash surrender value. (*Treas. Reg. 1.1275-1(j)*) Hence, private annuities never provide cash surrender values.

- If the trust is drafted with a beneficiary power under Code Section 678 (a beneficiary power to direct the trustee to distribute trust assets to himself/herself), that beneficiary will be deemed to “own” the trust estate for income tax purposes. Thus the income tax effect is the same as making that beneficiary the payor. The beneficiary will report all income, deductions, and credits of the trust, and the trustee may be authorized to reimburse the beneficiary for the added tax. The trust (thus beneficiary) acquires a fair market value basis in the exchange property useable to avoid any capital gain tax on its subsequent sale. The annuitant reports gain and ordinary income on the annuity installments (but not the tax-free ratable recovery of basis) under the annuity rules of Code Section 72.
- To avoid a retained interest claim by IRS under Code Section 2036(a), some think it prudent to authorize the trustee to make beneficiary distributions during the annuity payment period.
- Finally, the annuitant may exchange a *remainder* interest in the property for the private annuity. He retains the use and enjoyment of the property for life, and the annuity payments are reduced proportionately. That means, of course, that the payor must fund the annuity payments from personal resources.

Private annuity transactions usually take the form of an irrevocable gift trust for the children with nominal funding, followed by an exchange with the children as co-trustees. They, in turn, may contract with a bank trust department to provide the accounting, administration, portfolio management, and tax reporting services. The bank fee is ordinarily around 1% per year.

The private annuity may deliver dramatic benefits on the right facts, and the methods of dealing with principal invasion and other concerns are myriad. We'll leave it by saying that it is an important arrow in the lawyer's quiver.

Practical Considerations. As already twice mentioned, the obligation to make the annuity payments cannot be secured without risk of capital gain recognition. (*Estate of Bell* 60 TC 469 (1973)) "Informal" security may be obtained for *one* significant risk, however: the payor's premature death. The payor may die before the annuitant, with the obligation continuing as that of the payor's estate. The heirs and other creditors of the deceased payor may not have the payor's charitable instincts. So, especially if the estate is short of cash to pay taxes and costs of administration, collecting the post-death annuity payments may prove problematical. Consequently, it may be advisable to insure the life of the payor with a low-cost term life insurance policy, perhaps decreasing in order to track the decreasing balance on the annuity obligation. The payor should be both applicant and owner, and his or her estate should be the named beneficiary. At death, the policy proceeds are included in the payor's gross estate, offset by the annuity obligation owed to the annuitant. If the amount involved is large enough to justify the transaction costs, the estate may be left with the obligation as an estate tax deduction while shifting the policy proceeds out of the estate by means of an irrevocable life insurance trust.

Additionally, life insurance can be an ideal medium for equalizing the assets going to different children. For example, if a business is the exchange property, and two daughters are active in it, its value is gone -- as is the income stream -- on the annuitant's death, leaving the non-participating son with no inheritance to that extent. Perhaps that works, since after all the daughters bought the business with their promise of a life annuity, but certainly if viewed to some extent as a gift, an adjustment is appropriate. Life insurance with the premiums paid by either the daughters or the annuitant, is a convenient way to do it in exact denominations.

There are a number of practical considerations in evaluating private annuities for estate planning:

- In theory, any type of property may be used for the private annuity transaction. The benefits are greatest, however, where the annuitant either wants to spread the capital gain and recapture taxes on appreciated property, or wants to avoid estate taxes. Since the annuity tables required by IRS are based on a fluctuating interest rate fixed on the date of exchange, income-producing property generating a return higher than that fixed rate performs best in keeping the cost to the payor manageable. If the return is inadequate or nonexistent, the property must be sold and reinvested. Fortunately, the new basis of the Payor in the exchange property facilitates sale by avoiding capital gain and recapture taxes.
- In order to protect against an IRS claim that the transaction was not made "at arm's length" (*i.e.*, was a product of collusion to improperly reduce taxes), the annuitant and payor may consider engaging separate attorneys.
- If the annuitant is concerned about giving the payor a windfall by dying prematurely (as in the exchange of family company stock for the annuity with key employees as payor), *an alternate* approach (*e.g.*, an installment sale) should be considered.
- Private annuity case law deals almost exclusively with single-premium *immediate* annuities. On specific facts, a single or annual premium *deferred* annuity may prove attractive, keeping in mind that the absence of supporting case law means there is less predictability (for its treatment by the courts) than is the

case with immediate annuities. If a relatively untested form is desired, a private letter ruling should be requested from IRS. It will clarify the effect on the integrity of the transaction as a private annuity.

- The Payor may be unimpressed with the idea of buying what he or she expects to inherit. There are at least two reasons to acquire it by means of a private annuity: it eliminates all doubt (for example, a will can be changed, but the private annuity agreement cannot be modified without the consent of both parties), and liabilities that could consume the property in its present form (*e.g.*, the costs of long-term nursing home care) may be managed.
- Sometimes, the payor develops a startling interest in the longevity of the annuitant, one that could disrupt an otherwise healthy family relationship.
- Examine the risks. To the annuitant, the private annuity is an alternative to leaving the property by will, or otherwise. To the payor, it is an investment and should be evaluated as such.
- If the annuitant outlives his life expectancy, the payor pays more than expected; perhaps much more.
- If the annuitant outlives his life expectancy, the capital gain portion of the annuity installments become ordinary income.
- The payor receives no income tax deduction for the annuity payments. The need to earn a large enough pre-tax investment return to permit the payment of annuity installments without principal invasion may place investment pressure on the payor leading to unreasonable investment risks.
- The annuitant must rely on the payor's unsecured promise to pay.
- The annuitant is at risk that the payor's creditors will take the property and leave the payor without the resources from which to make the annuity payments.
- The payor's estate remains liable for the private annuity obligation, even if the payor predeceases the annuitant.
- Incorrect valuation may lead to unexpected gift or estate taxation.
- If the annuitant lives a long time, inflation will reduce the purchasing power of the annuity payments. It will also make it easier for the payor to make the payments.
- If the annuitant is up in years, the annuity payments may be unaffordably high, requiring more aggressive planning in order to obtain the desired economic results.
- If the annuity payments are not needed for the annuitant's living expenses, the accumulation of excess income will increase the estate value, offsetting some of an important advantage to the private annuity.

Forced Recharacterization by IRS. Another practical consideration is the risk of recharacterization of the private annuity exchange as a transfer with retained interest. If recharacterized, the exchange property is included in the annuitant's gross estate under Code Section 2036(a), and annuity taxation under Code Section 72(h) is denied. It sometimes happens when (a) the Payor has no personal resources available for use in servicing the private annuity obligation, and (b) all relevant facts and circumstances are not fully considered, (c) implementation of the transaction is incorrect or incomplete, or (d) all of the above.

This has led to a conventional wisdom in the tax bar that the way to avoid recharacterization is to be certain

that the payor has funds other than the exchange property on which to draw in servicing the annuity obligation. Close examination of the cases in which IRS succeeded with the retention argument reveals that this is absolutely not the case. The Payor need not have personal resources, but the transaction must be competently and completely carried out.

A BNA tax article on private annuities adopts the conventional wisdom. The writer delivers a dire warning that unless the Payor of a private annuity owns or is capitalized with property equal to some substantial amount in excess of the obligation undertaken, the transaction could be treated as a transfer with a retained interest causing the exchange property to be fully included in the estate of the transferor for federal estate tax purposes.

Remember, Dad gives Son the family farm in exchange for Son's unsecured promise to pay Dad \$1,000 per month for life. That (\$1,000) figure is the product of annuity factors found in the regulations for Code Section 7520, and is calculated using an interest rate equal to 120% of the applicable federal midterm rate on the date of exchange. *After* the exchange, Son holds unfettered title to the farm, and Dad has a lifetime stream of income. Any capital gain realized by Dad on the exchange is reported ratably over his remaining life expectancy, and Son has a fair market value basis in the property, enabling him to sell it with little or no capital gain taxation. On Dad's death, the annuity stops, leaving it valueless. This transaction effectively removes the farm from Dad's estate while maintaining his economic security.

The author of the BNA article takes the position, however, that Dad's estate may include the full value of the farm *if* Son was penniless at the date of exchange.

- The first citation lists several cases for the proposition that a retained interest in the exchange property leads to inclusion under Code Section 2036. Well, of course it does. But a properly-structured private annuity transaction is treated as an exchange, not a transfer with retained interest.
- The second citation is to *Revenue Ruling 68-183*, 1968-1 CB 308 for the proposition that non-liability of Son (in our example) militates in favor of a 2036 finding. Again, a properly-drafted private annuity agreement makes it clear that Son is indebted to Dad with respect to the agreement.
- The third citation is to *Bell Estate vs Commissioner*, 60 TC 469 (1973) for the proposition that Section 2036 applies if the annuity is secured. Nothing in a properly-structured private annuity agreement remotely resembles a security interest in the exchange property. The Payor owns it after the exchange, and has unlimited personal liability for the annuity payments.
- The fourth citation is to a tax court memo (*Mitchell Estate vs Commissioner*, 43 TCM 1034 (1982-185) for the proposition that the transferee/payor must have independent financial means from which to pay the annuity. *Mitchell* is distinguishable from our typical case.

Alma W. Mitchell was widowed on October 23, 1972. Her deceased husband left a clutch of farms and businesses, the management of which was assumed by one of their three children. She developed cancer, and one month before her death, transferred the properties to her children in exchange for a private annuity with a then-present value approximating the exchange property values. There was no plan by which the annuity obligation would be funded; there was no evidence that the properties were to be sold in order to create liquidity from which to fund the annuity obligation; and the amount of the annuity was at least 10 times the amount actually distributed to the widow.

The issue in *Mitchell* was not a Section 2036 retained interest; that section is not mentioned in the case at all. Inclusion of the transferred assets in the widow's estate was based on Sections 2033 and 2035. The court simply did not believe an annuity was intended, basing that conclusion on three observations: (a)

the widow's financial arrangements prior to the transfer, (b) the apparent inability of the children to pay the widow more than \$10,000 per month (the amount of the annuity), and (c) the widow's health at the time of the transfer.

Compare this fact situation to *Stern III* (*Stern vs US*, 650 F.Supp. 16 (D.Nev.1986)). There, Mr. and Mrs. Stern created two trusts, one funded with \$5,000 and one for \$1,000, transferred millions in Teledyne stock to them in exchange for private annuities blessed by the district court on remand from the third appeal to the Ninth Circuit. On the facts, *de minimis* funding served the purpose. The other two citations are *Stern vs United States*, 563 F.Supp. 484 (D.Nev.1983) (*Stern I*) and *Stern vs Commissioner of Internal Revenue Service*, 747 F.2d 555 (9th Cir. 1984) (*Stern II*).

- The fifth citation points to *Greene vs U.S.*, 237 Fd 848 (7th Cir 1956) and others for the proposition that when the amount of the annuity installment equals the income earned from the exchange property, it is too much to believe that it is not a retained interest. I agree, but competent counsel would never do that. The exchange property is ordinarily sold in the process of carrying out the transaction, so there *is* no property useful in making such a comparison. More to the point, the annuity amount is derived from Section 7520, and any similarity of annuity payments to exchange property income – or that of its sale proceeds -- is entirely accidental.
- Finally, the sixth citation is to *Greene* and a *Revenue Ruling* (79-94, 1979-1 CB 296) for the proposition that if it is unlikely that the Payor would ever have to apply its own resources to satisfaction of the annuity obligation, it must be a 2036 retained interest transfer.

The footnote describes the *Greene* annuity as being the exchange of a particular property with the annuitant's children for an "annuity" the amount of which is the greater of net income from the exchange property or \$3,000 per year. Because of the implicit agreement that the children would keep the property, and the apparent absence of any relationship to the 7520 rate required for the annuity, I would reach the same conclusion. Again, competent counsel would never make such a mistake.

The cited *Revenue Ruling* is no more helpful in supporting the BNA author's misbegotten advice. Here are the facts on which the ruling was based:

In 1965, *D* created a funded irrevocable trust and retained for life the right to the income from the trust corpus. Upon *D*'s death, the trust corpus was to pass to his children. In 1974, *D* transferred the retained right to income to his children in exchange for an annuity. The annuity arrangement provided that the children would pay to *D* during life all the income from the trust. For any year in which the trust income was less than 20x dollars, the children agreed to pay *D* the difference. When *D* transferred the income interest, he was 75 years old. *D* died in 1978. From the inception of the trust in 1965 until *D*'s death, the trust corpus had generated 30x dollars of income each year.

This looks just like the *Greene* case; the trust and its assets stayed in place, serving as the measure of the annuity payments, and the payments were 150% of the minimum required. Where is the application of 7520 reported? No mention of valuing the income stream and exchanging it for a private annuity of equal present value while obligating the children for payments in excess of trust income, steps that might have given wings to the aspirations of *D*. In short, the sixth cited authority bears no rational relationship to properly structured private annuities.

PAT Abuses

Recently, I was engaged as a private annuity expert in connection with a defamation case. The litigation

dealt with perceived misrepresentations by a hotel seminar operator. A particularly knowledgeable attendee posed some embarrassing questions, and the presenter sued him for defamation. My job was to opine on the correctness of his comments.

Abuses. After viewing the web site version of the seminar, along with 16 inches of documents produced by the plaintiff evidencing her background and beliefs on the subject, I testified that several talking points were false or misleading. Here are the issues that the informed investor would consider important, and that probably bother IRS most about domestic private annuities.

- Almost invariably, until publication of the proposed regulation ending the open transaction doctrine as to private annuities, appreciated property is exchanged for the annuity. This allows the annuitant to obtain a return based on the pre-tax value of the property, and to spread the recognition of gain over the annuitant's life expectancy. If the annuitant reserves the right to borrow on the security of the exchange property, or surrender the annuity and retrieve all or most of the exchange property, there will be no ratable recognition of gain, and valuation problems arise bearing on the gift tax issues. Rather, the gain will be all recognized in the year of the exchange. Gain deferral matters little if the purchase is for cash, but even then, a surrender value existing on the date of death is part of the annuitant's gross estate for federal estate tax purposes. For those reasons, the properly-drafted private annuity never provides for loan and surrender values.
- The sham transaction risk discussed in more detail as a step transaction below.
- As noted earlier, the interest rate to be combined with the Code annuity factor will render the transaction uneconomic if set too high. For instance, it was 11% in 1991. At that level, the payout rate is so high that the Payor hasn't a prayer of earning enough on the exchange property to avoid principal invasions, and thereby, the risk that the annuitant will outlive his or her money. At this writing, a string of quarterly increases in the federal discount rate have pushed the annuity rate to 6.2%, falling more recently to 5.8%. The Federal Reserve Board is finally beginning to sense that it tightened too much, indicating that the rate will start back down. We can only hope so. The lower the better.
- The step transaction is described by *Shepard's 1995-96 Tax Dictionary* (Richard A. Westin, McGraw-Hill, 1995) as follows:

"A judicial doctrine that applies to the entire field of federal taxation, under which separate steps of an overall transaction will be treated as part of a single transaction if the steps can be fairly integrated. (Citations omitted.) Three common variants follow: (1) under the *end result test*, the steps will be collapsed if the *taxpayer* intended the result that resulted from the steps; (2) under the *mutual interdependence test*, the steps are collapsed if each step is so dependent on the others that they would be futile unless completed collectively; and (3) under the *binding commitment test*, the steps are collapsed only if there is a binding commitment to take the subsequent steps. (Citations omitted.) The [U.S.] Supreme Court has suggested that the step transaction doctrine applies only if the steps are contractually agreed upon. (Citation omitted.) This position has been distinguished away in subsequent lower court decisions. (Citations omitted.) Nonetheless, the standards for determining whether to telescope a series of transactions remain unclear. (Citations omitted.)"

In a property tax reassessment case, *McMillin-BCED/Miramar Ranch North vs County of San Diego* (1995) 31 CA4th 545, 555-556, 37 CR2d 472), the court noted that the step transaction doctrine could be applied even though only one and not all three of the tests were met.

At bottom, an intent to minimize taxes in and of itself does not invalidate a transaction for income tax

purposes. The fact that one form is adopted over another in order to minimize the tax will not deprive the annuitant of the benefit sought. IRS will consider the substance of the transaction for its true nature, in order to determine the proper tax consequences. From its standpoint, it is the substance of the transaction that matters. (*E. F. Gregory*, SCt. 35-1 USTC Section 9423, 293 U.S. 465) The usual result is that if the annuitant casts a taxable transaction in a nontaxable form, he may have a difficult time persuading IRS that the substance differs from the form for tax purposes. (*L. Danielson*, CA3, 67-1 USTC Section 9423, 378 F2d 771, cert. denied, 389 US 858) The general rule is that IRS may look behind the form of a transaction in order to determine its substance for tax purposes, but the annuitant is usually locked into the form; *i.e.*, he will have some difficulty in arguing that the transaction substance is different for tax purposes.

The step transaction doctrine is part of the substance versus form analysis. Generally, it requires that the transaction must be viewed as a whole, not broken into its component steps for income tax purposes. Also related to the conclusion reached by IRS is the matter of control. If the annuitant is able to control the timing, the parties, or the method of carrying out a taxable transaction, he can usually control its tax results. But once the transaction is completed, you rarely have a choice as to the tax consequences. This is because he cannot disregard the form chosen. Accordingly, tax planning must be based on an examination of the tax rules *before* carrying out the proposed transaction.

Control over the form of a transaction, for example, may make it possible to turn a sale into an installment or private annuity transaction so that profit may be reported on the installment basis or as an annuity. Control over the timing may involve deferring completion of the transaction by placing the event and resulting income or loss into a more advantageous tax year. Control over the parties may make the income taxable to another person without any actual detriment to the taxpayer exercising the control. Common examples are family gifts of income-producing property or property about to be sold and the splitting off of part of a corporation's business and the related income.

Taken together, the private annuity survives the form-over-substance and the step transaction doctrine quite nicely. It is a transaction that has stood the test of time over a century or more. See, for example, the Ninth Circuit's repeated approval of the private annuities in *Stern v. Commissioner*, 650 F. Supp 16 (1986), notwithstanding structural frailties that could have proven serious if the case had arisen in the Sixth Circuit.

- There is a gift requirement imposed by IRS on private annuity transactions in which the Payor is a trust. Discussed in detail elsewhere as the "exhaustion test," it is unlikely to withstand a legal challenge.
- At this writing, the federal capital gain tax is 5% or 15%. When *The Jobs and Growth Tax Relief Reconciliation Act of 2003* expires at the end of 2008, the rates will return to 10% and 20%. The point of the criticism is that selling the property for cash incurs a federal capital gain tax of 15%, whereas deferring the tax by exchanging the property for a private annuity may result in a higher-than-expected tax because of future rate increases. To reach a disciplined conclusion, you must run the numbers. Remember that the tax is reduced by as much as half by the time value of money; *i.e.*, the 15% tax the annuitant would have paid on a cash sale remains largely in the bank, earning interest, and in many cases reducing or eliminating the capital gain tax. Even if the rate increases 25% to 20%, he still winds up paying 10% or less when he counts the interest earned by the tax that wasn't paid up front. For example, let's look at a sale or exchange of property for \$1 million, basis \$500,000.

Cash Sale The capital gain tax for a cash sale is \$75,000 (\$1 million – \$500,000 basis x .15%).

Private Annuity The annuitant is age 60. The life expectancy 24.2 years. The portion of the annuity payment allocated to recognition of gain is \$21,097 per year. The tax is 15% (\$3,165 per year) for the first two years, and 20%

(\$4,219 per year) for the remaining 22 years. Note that the total allocations is greater than the cash sale figure. This is related to the actuarial probability of dying during the term without having to report the remainder of the gain. (That same actuarial probability applies to tax-free recovery of basis; the annuitant recovers more tax-free dollars than he would on a cash sale) If he put \$75,000 in the bank at 6% (4% after tax), pays the capital gain tax in installments over 24 years under the annuity, the interest on the money the annuitant did not have to pay up front reduces the actual cost of the tax from \$75,000 to \$43,390 (\$99,148 in allocations of the annuity installments, less \$55,758 interest earnings from interest on the deferred tax), even assuming a return to the 20% capital gain tax rate.

Here are the tracking numbers:

Year	The Cash Balance on Sale After-Tax	Installment Tax Payment With Cash Sale Private Annuity	Balance	Interest
				4%
		1. \$75,000	\$ -0-	
		\$75,000	\$3,000	
		\$78,000		
		2. 78,000	3,165	
		74,835	2,993	
		77,828		
3.	77,828	3,165	74,663	2,987
4.	77,650	4,219	73,431	2,937
			77,650	
			76,368	
		5. 76,368	4,219	
		72,149	2,886	
		75,035		
		6. 75,035	4,219	
		70,816	2,833	
		73,649		
		7. 73,649	4,219	
		69,430	2,777	
		72,207		
		8. 72,207	4,219	
		67,988	2,720	
		70,708		
		9. 70,708	4,219	
		66,489	2,660	
		69,149		
		10. 69,149	4,219	
		64,930	2,597	
		67,527		
		11. 67,527	4,219	
		63,308	2,532	
		65,840		
		12. 65,840	4,219	
		61,621	2,465	

					64,086			
					13.	64,086	4,219	
						59,867	2,395	
						62,262		
					14.	62,262	4,219	
						58,043	2,322	
						60,365		
					15.	60,365	4,219	
						56,146	2,246	
						58,392		
					16.	58,392	4,219	
						54,173	2,167	
						56,340		
					17.	56,340	4,219	
						52,121	2,085	
						54,206		
					18.	54,206	4,219	
						49,987	1,999	
						51,986		
					19.	51,986	4,219	
						47,767	1,911	
						49,678		
					20.	49,678	4,219	
						45,459	1,818	
						47,277		
				21.	47,277	4,219	43,058	1,722
						44,780		
22.	44,780	4,219	40,561	1,622		42,183		
23.	42,183	4,219	37,964	1,519		39,483		
24.	39,483	4,219	31,045	1,242		32,287		
25.	32,287	<u>4,219</u>	28,068	<u>1,123</u>		29,191		
				TOTALS		\$ 99,148		\$ 55,758

IRS Response

On October 17, 2006, IRS published *Proposed Treasury Regulation* 1.41901-05. A copy is attached as *Appendix 1*.

It purports to withdraw application of the open transaction doctrine to the exchange of appreciated capital assets for an unsecured private annuity. This requires recognition of the gain in the year of exchange, and is based on unspecified “abuses” of domestic “Private Annuity Trust” transactions. The proposed regulation is open for comment from the tax bar for a time, and unless withdrawn, is to be effective retroactive to October 18, 2006 once it transitions from the comment period to temporary regulation status. Public hearings were held in Washington D.C. on February 16, 2007. At this writing, no information was available as to the future of this proposed regulation.

In my view, much like the IRS-imposed “exhaustion test,” there is no support for termination of open transaction treatment. It has served as substantial legal authority under case law going back to 1931. The proposed regulation falls short of implementing IRS’ authority in a reasonable manner. As such, it is an invalid extension of IRS authority. Ending an established, well-reasoned, practice in this manner is patently arbitrary (based on IRS preference), and as such, an invalid exercise of its regulatory powers.

If this proposed regulation becomes law, it may be challenged on the grounds stated (and others that may occur to fertile minds), but caution suggests that the annuitant either plan on defending the transaction, or sell the property first, pay the estimated tax and purchase the annuity with after-tax dollars. The avoidance of gift tax, estate tax, and generation-skipping transfer tax is unaffected by the proposed regulation.

Because the proposed regulation may never become law (or may be successfully challenged), I have discussed private annuities herein as they existed prior to this IRS action. Just keep this caution in mind as you read the material.

Following is my contribution to the public hearing discourse on the proposed regulation:

October 30, 2006

CC:PA:_PD:PR (REG-141901-5)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: *Comments on Proposed Treasury Regulation 141901-05*

Dear Sir or Madam:

Invited comments include “. . . (v) circumstances, if any, in which the fair market value of an annuity contract for purposes of §1.1001-1(j) should be determined other than by tables promulgated under the authority of section 7520;” The following addresses that and other issues raised by the proposed regulations.

Calculating the Value. The value of an unsecured promise to pay a private annuity is indeed problematical. A reasoned value should be based on an independent appraisal taking into account:

- the resources of the payor, including the added resources forced by the “exhaustion test” (*Treasury Regulations 1.7520-3(b)(1), 20.7520-3(b)(1) and (2), and 25.7520-3(b)(1)(2)*);
- the creditworthiness of the payor; and
- the probable after-tax rate of return, earned by the payor on the exchange property (or its sale proceeds) and available to service the private annuity obligation.

Where, however, does that take the transaction? The potential for discounting abuses pertaining to the various forms of exchange properties remain, and would be complicated by the prospect of dispute over whether a gift by or to the payor took place. This would lead to administrative chaos.

Historically, the present value of the private annuity is a straightforward mathematical calculation, while the exchange property (other than cash) is transferred at its date of exchange appraised value. Any disparity determines the existence of a gift element. Realization with ratable recognition of gain on the exchange serves to automatically reconcile the transaction with reality. On the premature death of the annuitant, part of the capital gain tax is already paid from the annuity payment allocation under *IRC* Section 72, and exchange property basis is adjusted in the hands of the payor, leading to eventual payment of the balance.¹ If the annuitant lives out the life expectancy, the tax is fully paid from the Section 72 allocation.

The proposed regulations retain the present value calculation, without adjustment for resources and creditworthiness of the payor. Any gain realized by the annuitant on the exchange, however, is recognized immediately. This distorts the result for the one who dies prematurely: the tax is fully paid; the annuitant receives less than the value of the exchange property; and the payor still receives a basis adjustment (to the sum of the payments made to date of death). Result, the tax is paid twice: once on the exchange, and again on the payor's sale of the property with a reduced tax basis.

There is no virtue in, nor reasoned basis for, placing the commercial annuity, the secured private annuity, and the unsecured private annuity all on the same footing.

Commercial annuities are secured by institutional assets. Secured private annuities are afforded the same tax treatment as commercial annuities; *i.e.*, commercial annuities are bought with after-tax cash, and secured private annuities are bought with appreciated assets, with full recognition in the year of exchange. It is the *unsecured* private annuity receiving short shrift.

Application of the proposed regulations serves to abandon a time-tested method of dealing with payor default risk in favor of one that is unduly burdensome. Under the proposed regulations, the taxpayer receives a lifetime stream of income for the exchange property, but pays the full capital gain tax on a gain that may never be fully received. Even if basis adjustment in the hands of the payor is nullified, this is an unfair burden on the annuitant.

Taxpayer – a widower, age 70 – is laid off. No new prospects. His house is unencumbered, he has \$30,000 in savings, a Social Security retirement benefit of \$1,500 per month, and no pension. His only asset aside from his home and cash is 50 acres of undeveloped desert land near a resort area bought for appreciation years earlier. His cost basis is \$10,000, and it has appreciated to \$200,000. If he sells it, the proceeds are reduced by almost \$30,000 for capital gain tax, and the \$170,000 cash remaining will purchase a private annuity of \$1,601 per month. If he exchanges the property for a private annuity, he receives \$1,884 per month. In the latter case, the proposed regulations require that he exhaust his savings due to immediate recognition of gain, in order to obtain a level of income permitting the most dignified retirement possible under the circumstances. If he has a stroke and dies after a few years, the full gain is prepaid, but he does not receive the full value of the exchange property. Moreover, exchange property basis is adjusted in the hands of the payor, leading to a second partial recognition of the same gain.

Conclusion. The regimen in effect since 1931 has worked well. Any perceived modern-day abuses may be challenged on their merits.

I have served as expert witness in one action involving a seminar operator for “Private Annuity Trusts.” In that engagement, I saw gross misinformation, but not overt abuses justifying a change in a body of law serving us well for 75 years.

The open transaction doctrine works well in practice. It should be retained.

Sincerely,

F. BENTLEY MOONEY, JR.

FBM:mc

The Economics

The discussion thus far deals with the nature, characteristics, and tax aspects of the private annuity. So let's consolidate this information in a practical way before moving on to more esoteric matters. The proposed annuitants are Californians, and married. They are both 60 years of age. They own a four-unit apartment building purchased in 1994 for \$700,000, depreciated since then to \$600,000, and now worth \$1.7 million. They want to dispose of the property and retire, doing so in the most tax-efficient manner possible.

You ask: "How do they exit the market without being pillaged by the IRS?" If they sell for cash, they're out \$264,000 for state and federal capital gain taxes.

One option is an installment sale: take a small down payment and the buyer's secured installment note for the balance. This spreads recognition of the capital gain over the term of the note. (It would not spread recapture, if the annuitants had any.) But the note balance is fully included in the annuitants' estate for federal estate tax purposes on death during the term.

Another is to give the property to a charity in exchange for a life income that – using actuarial calculations – leaves it some amount (minimum 10%) on death of the annuitant. At age 60, it will produce a life income of \$119,000 per year and a one-time charitable deduction of \$259,493. They may take the income tax deduction in the year of the exchange. In strictly economic terms, they receive 85% of the property value as a life income, plus an estimated 30% of the deduction as a reduction in income taxes, a total of \$1,523,000.

Another is a sale in exchange for a self-cancelling installment note (SCIN). To achieve the tax aims, their joint life expectancy must be longer than the term of the note. The note is cancelled on death, thus removing the balance from the gross estate for estate tax purposes. The installments are taxed to the annuitants' as a private annuity, thus also permitting deferral of capital gain and recapture taxes. There are, however, competing costs and benefits to be evaluated:

- A cancellation premium must be added to the interest rate in order to reflect the actuarial value of the buyer's benefit if holder dies before the note is fully satisfied. There is no broad agreement on how to calculate it, but it is both complicated and substantial. In most cases, the premium on either the price or the interest rate will be 25% to 30%. Where applied to the price, it is always based on full market value exclusive of any discounts for lack of control and limited marketability.
- If the premium is not included, its value is reportable as a gift. (*Moss vs Commissioner*, 74 TC 1239 (1980))
- The balance cancelled on death is taxed to the buyer as "forgiveness income." Any portion of the cancelled balance representing unrecognized capital gain is reported on holder's (decendent's) final income tax returns.
- With both the SCIN and the private annuity, appreciation of the exchange property is shifted to the buyer.
- If the transaction goes full term, the buyer winds up paying much more than market value because of the premium, and the seller may wind up with more property included in his estate because of receiving full price *plus* the premium.
- The interest paid is deductible for the buyer, and the note may be secured, whereas the reverse applies to the private annuity.
- Tax deferral under a SCIN is available only up to \$5 million, but is unlimited in the private annuity

transaction.

- The holder might try an interest-only SCIN with a balloon payment if he expects to die before the end of the note term. This may enable him to move the entire value of the property out of the estate without incurring a gift tax. It should work, so long as the holder does not get so greedy that IRS deems it profitable to attack the transaction.
- The balloon payment tactic described above may be taken to new levels by selling the property to a grantor trust, rather than directly to a family member. A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction. (*Dobson vs Commissioner*, 1 BTA 1082 (1925); *Revenue Ruling 85-13*, 1985-1 *Cum Bull* 184) So, if the holder is not deemed to be the owner of the trust for estate tax purposes, but *is* the deemed owner for income tax purposes, capital gain is realized but not recognized when the property is sold to the trust in exchange for a SCIN. The holder is not taxed on interest paid by the trust. There are important gift tax determinations to be made (Code Section 7872), but it is worth considering.

On balance, the SCIN is useful only where the buyer is a natural object of the seller's bounty. The mortality premium, however, is usually so high that it is eliminated on economic grounds.

A fourth planning option is to exchange the property for a private annuity. This transaction puts the annuitant's family on both sides of the table. He does not buy a commercial annuity from Prudential, where he must first reduce the property to net cash after taxes, then forfeit to the insurance company any value remaining at death. Instead, the *children* issue the annuity to the parent or parents in exchange for the *unsold* property in order to keep the *pre-tax* value in the family. For example, the annuitant establishes an irrevocable gift trust for the children, funded with \$10. Then he conveys the property to the trust in exchange for a private annuity evidenced by a simple four-page agreement. The children as co-trustees engage a bank trust department to provide bookkeeping, administration, investment, and tax reporting services for a wrap fee of 1% per year of exchange property value. The trust sells the property. The trust gave an annuity worth \$1.7 million for the property, so it has a full fair market value basis in it, thus it has no capital gain on the sale. The bank invests the proceeds in a professionally-managed portfolio of securities from which the annuity is paid. The annuity amount is set under the Code, and the U.S. Treasury Department sets the interest rate to be used with the annuity factor in calculating the annuity. The proposed annuitant and spouse receive a life income of \$120,619 per year. That private annuity installment represents 7.1% of the initial exchange property value. So, if the trust investment manager is able to earn more than that rate, net after taxes, no principal invasions are ever required. That gives them \$3,341,146 in total annuity payments over the 29.7-year joint life expectancy, and at least \$1,700,000 is left in the trust for the children at the survivor's death. This is the best payoff so far.

Although the private annuity is the most promising exit plan, if the annuitant is much older than 60 years of age, he will be whipsawed by taxes in *another* sector: those the trust must pay on portfolio earnings. If it takes 7.1% to satisfy the annuity obligation, the trust must earn at least 12% before taxes in order to avoid invading principal. Principal invasions, of course, present a risk that the annuitant may outlive the money. It essentially turns the transaction into an installment sale. That's not all bad, but needs some fine-tuning in order to garner all possible benefits. One tool for that is the foreign private annuity.

Fine-tuning the private annuity involves moving the trust to a country that imposes no income tax on portfolio earnings. There are many such countries built around servicing transactions like the private annuity. These countries are stable – one has a national legislature in continuous operation for more than 1,000 years – and they have ample numbers of English-speaking lawyers, accountants, management companies, international banks, and corporate trustees. If the trust need not pay income taxes on portfolio earnings, the manager may invest more conservatively, adding to the safety of the funds backing up the

annuity.

The costs are about the same as using a U.S. bank for ongoing management services, so where is the downside? If there is one, it is the transaction costs. This is a complex transaction, and to do it successfully, it must be conducted by an expert. The cost of that expertise, however, is more than offset by the economic benefits of taking the transaction offshore.

In our example, the amount of the annuity remains \$120,619 per year (IRS still sets the annuity factor and the interest rate). But because the portfolio earnings are not taxed, either there or by the U.S., there is no pressure to take investment risks, therefore less likelihood of principal invasions. This means greater security for the annuitant. Think about this: if the portfolio manager is able to net 8.1% in a no-tax country, it leaves \$17,000 per year to accumulate at that rate throughout the joint lifetime of the annuitants and that of the survivor. Assuming that one of them lives as long as the joint life expectancy on the date of exchange (29.7 years), they receive \$3,341,146 in annuity installments over that period, and \$6.4 million is left in the trust for the children. They may arrange for fixed cash gifts from the trust to the children on the survivor's death (income and estate tax-free under Code Section 663), or may leave the funds in trust to generate income for the children and their descendants for a century or more. The \$6.4 million total economic value of the foreign private annuity makes it the most profitable exit plan of all.

Following are a few examples of the foreign private annuity applied to common fact situations, keeping in mind that capital gain taxation may not be deferred if the *Proposed Treasury Regulation* 141901-05 becomes law.

The following case studies illustrate the use of the foreign private annuity under varying facts and circumstances. The baseline considerations are the tax impact and the age of the proposed annuitant.

Not to put too fine a point on it, but if we assume that professional portfolio management of the exchange property sale proceeds by or on behalf of the Payor will average 8% net per year, the annuity payout rate must be less than that figure in order to avoid principal invasions. Avoiding principal invasions avoids the risk of outliving the money.

With a domestic private annuity, the 8% net return must be reduced by income taxes owed by the Payor. That Payor is usually a trust. Trusts are heavily taxed for income tax purposes, hitting the maximum bracket at roughly \$10,000 of retained earnings.

Part of those retained earnings, however, are capital gains taxed at 15% federal. If we add 5% for state income taxes, we may assume a combined rate of 20% for capital gain taxes and 40% for ordinary income (interest, dividends, etc.). Assuming that the 8% net return is 2% ordinary income and 6% capital gains, the net after-tax amount is 6% ((40% x 2%) + (20% x 6%)). Over the past couple of years, the internal interest rate mandated by the Treasury Department in calculating private annuities has ranged from 4.6% to 6.2% and rising. For analysis purposes, we will assume a mandated rate of 6%. With those assumptions, there is *no* age at which a domestic private annuity payout rate is 6%; *i.e.*, at *any* age, some principal invasion is required.

The foreign private annuity payor corporation as here described owes *no* income taxes to the U.S. on retained earnings other than a minuscule amount on U.S.-source dividends. Thus, the full 8% net return is available to service the annuity obligation. With the same root assumptions (8% net return, 6% mandated internal rate of interest), the payout rate is 8% or less up to age 51 for a single annuitant, and ages 62/61 for a joint and survivor annuity.

So, how are the needs of older annuitants met?

- Some need no special arrangements simply because the transaction is viewed as a capital gain/recapture deferral transaction, and they want the money back in their bank account as soon as possible. They may have other plans for delivering their estate to the children, or perhaps they have none (or dislike them).
- In most cases, however, the annuity payable to the older annuitant is usually much more than they need for living expenses. In a borderline case, we may use an inflation-adjusted annuity in order to accumulate excess portfolio earnings in the early years for later use in meeting higher payout requirements.
- For the others, a different transaction structure may be employed. We still use a foreign non-grantor trust, but (a) we use a single premium deferred annuity with installments commencing on 30 days' notice, and (b) the trustee is authorized to distribute to the trust settlor/annuitant portfolio earnings in excess of the amount required to maintain the annuity. The 6% internal rate required by the Treasury Department in our assumptions is fixed upon execution of the deferred annuity agreement. The 8% net earnings rate assumed leaves up to 2% per year for distribution. Some excess earnings should be held for use in a poor earnings year of course, but this generally produces a 2% distribution rate. As before, we have no gift tax, no estate tax, and no GST tax. If the 2% distribution rate suffices, the annuitant will never exercise the power to start the fixed installments, so all of it passes to (or for the benefit of) the children and more remote issue.

Study 1.

Harold started a publishing company in 1970 that grew to a substantial enterprise. Winifred is not involved in the business, nor are their three children. Harold and Winifred are now 61, love to travel, but publishing deadlines make it almost impossible to take that dream trip. Harold believes the company would sell for about \$10 million. They have about \$3 million in homes, automobiles, and other assets; no debt. Both Harold and Winifred are in good health.

They obtain an appraisal of the company and transfer it to the Payor in exchange for a private annuity, the latter with a \$10 million present value. The Payor will market and sell the company, and Harold will continue to manage it for a salary until the sale is closed. Following the closing, the Payor will begin paying Harold and Winifred an annuity of \$798,070 per year, payable for as long as either of them lives, spreading the capital gain reporting over their joint life expectancy of 25 years. If the Payor's portfolio manager earns 8% net average return on investment, it pays the annuity entirely from income and capital gains, leaving a nominal amount to accumulate at that rate. At the end (death of the survivor), they will have received more than \$19 million over their joint life expectancy, and the assets backing up the annuity will remain at slightly more than \$10 million in value. Those remaining assets pass to the trustee for the benefit of their heirs. As much as \$5 million in estate tax is avoided, and no GST tax will ever be incurred. All this is accomplished without paying a gift tax as a toll charge.

Study 2. (Actual case.)

Jack and Jill were married for a number of years, the second marriage for each, and two children each from the prior marriages. Jack had a highly successful medical practice in southern California. Jill was one of two children of a reckless, dishonest, trust fund baby. Jill's father and brother one day found themselves broke, after a lifetime of living on \$75,000 per month and losing lawsuits as they endeavored to cheat their business partners. Jill had served as an officer for several corporations owned by her father and brother, signing papers put in front of her, trusting that all was proper. Then she began receiving dun notices from banks and finance companies on defaults in airplane loans and personal guarantees. By the time she figured out what she had signed without reading, and that her name was forged on others, she was hit with

three lawsuits for almost \$3 million.

Around the same time, Jack was diagnosed with a rare form of bone cancer, and given five years to live. The only medical facility specializing in his form of cancer was located in Texas.

Jack and Jill entered into a prenuptial agreement when they were married. Under it, Jack's home and medical practice were characterized as his separate property. They had also accumulated about \$300,000 in savings. Jack's life also was insured for \$500,000 under an association group term life insurance certificate.

Jack and Jill sought legal advice on how to protect their separate and community assets from the claims of these creditors, taking into consideration the need to move to Texas for clinical trials. The attorney advised them that both California and Texas law protects the separate property of Jack from lawsuits against Jill. He also advised them that Texas has an unlimited homestead exemption from the claims of judgment creditors. The homestead law requires that a certain amount of time pass before the exemption applies, but estimated that they had time to make it work.

The practice and the home were exchanged for a \$2 million foreign private annuity, the attorney arranged for a life settlement sale of the term policy for \$375,000, Jack put in a claim on his disability income insurance policy, and they moved to Austin. There, they purchase a beautiful home with the community property cash, and Jack began treatments at the clinic. At bottom, his medical insurance paid the treatment costs, his disability policy pays \$6,000 per month, his Social Security Disability payments are \$2,000 per month, and the private annuity pays \$9,000 per month for as long as either Jack or Jill survives. All this serves to remove financial pressure on Jack while he fights for his life. Jill is able to blow off the creditors on the basis that their community property home is exempt from their claims, and Jack's separate property is protected by both the state exemptions.

Study 3. (Actual case.)

Tom and Jerry, father and son, are real estate developers. Tom is 74, his wife is 71, and Jerry is 45. They are partners in a family limited partnership the primary asset of which is a large apartment building. The real estate market is cooling, and they would like to take some chips off the table. Tom and his wife aim only at deferring capital gain taxation, and otherwise want the money back in their account as soon as possible. Jerry has five children under seven years of age, and a prenuptial agreement with his wife to protect his substantial net worth. His aim is to provide lifetime economic security for his children and more remote issue, and eventually to support some favored charitable interests.

Tom and his wife exchanged a limited partnership interest for a \$16.5 million immediate private annuity paying \$1,692,950 per year for as long as either lives. That income is \$552,486 tax-free return of basis, \$359,116 capital gain, and \$781,348 ordinary income. The payout rate is more than 10%, so the payor's portfolio manager may be hard put to avoid principal invasions, but Tom and his wife are unlikely to outlive their money. At the death of the survivor, the remaining funds from the exchange property is distributed to a trust for the benefit of their children and more remote issue.

Jerry – alone and without his wife involvement – chose a single premium deferred annuity in the same amount, commencing at his age 65. The IRS- mandated interest rate of 6.2% will have the age 65 annuity based on an accumulation of \$54,950,833. However, it is likely that the

payor's portfolio manager will earn a net return 2% higher than the mandated rate. If so, the real accumulation will be on the order of \$79,804,827. At age 65, he will begin receiving an annuity of \$6.8 million for life. That represents a payout rate of 12% based on the accumulation using IRS figures, but 8.5% based on the *actual* accumulation. As a result, around \$80 million winds up in the family trust after Jerry has received \$136 million in annuity payments. No estate, generation-skipping, or gift taxes.

Study 4.

In 1959, Harry read *How I Turned \$2,500 into \$1 Million in Real Estate in My Spare Time*. He was 20 and newly married, working as the manager of a May Company shoe department. Harry and Wilma borrowed \$2,500 from her parents and bought their first house. They worked nights and weekends to attend to cosmetic repairs, then entered into a Code Section 1031 tax-deferred exchange of the property for a duplex. In the decades following, they traded aggressively, accumulating by the age of 70 a \$30 million stable of properties, all in California. Although the economic security represented by the properties was satisfying, the hard work and risks required to accumulate them took their toll. Harry now has high blood pressure and Wilma is beginning to slow down. If they are ever to smell the roses, now is the time. They want to sell the properties, put the money in the bank, fly to a small hotel on the Amalfi coast, remind each other daily why they married more than half a century earlier, and never again pick up a cell phone. But there is a problem. State and federal recapture and capital gain taxes on the order of \$9.8 million. When their five children heard about these aspirations, a long line of life insurance agents and assorted investment and tax counselors lined up to show Harry and Wilma how to avoid those taxes. They heard about charitable remainder trusts, Nevada corporations, Luxembourg foundations, tax shelters, financed life insurance, and more. Now burdened by serious migraines, they turned to the foreign private annuity.

False Start. Their attorney ran the numbers for a level-payment joint and survivor immediate private annuity. The properties were appraised for \$30 million. The present value of the annuity would be the same. The Payor would sell the properties, paying no income taxes because it had given \$30 million for them (giving it a tax basis of \$30 million). The annuity would be \$2,585,650 per year, payable for as long as either of them lived, spreading the capital gain and recapture reporting over their joint life expectancy of 21 years. If the payor's portfolio manager earned 8% net average return on investment, it pays the annuity primarily from income and capital gains, reducing principal by \$185,650 per year. At the end (death of the survivor), they will have received \$54,298,650 over their joint life expectancy, and the assets backing up the annuity will have declined to \$6.1 million. Those remaining assets pass to the trustee for the benefit of the heirs of Harry and Wilma. The estate tax is avoided, and no GST tax will ever be incurred. Again, this is all accomplished without paying a gift tax as a toll charge.

Alternative. Harry said, "Wait a minute. We never earned more than \$600,000 from the real estate, what do we need with \$2.6 million a year? I'd rather leave more for the family."

"OK," said the attorney, "let's make it a deferred private annuity, with installments to begin at then-current age on 30 days' notice. We will provide in the foreign trust that the trustee may receive and distribute to you – with the consent of the children – whatever portfolio earnings exceed the interest rate required by IRS for the annuity accumulation value. Right now, the required rate of interest is 6%." So, the \$30 million grows at 6%, and the 2% excess earnings are paid from the Payors to the trust as a dividend, then passed through to you as trust beneficiary. Now, you have \$600,000 per year, increasing annually as the accumulation fund grows in value, and the kids wind up with a trust on the order of \$120 million. No gift tax, no

estate tax, and no GST tax.” “Now, we’re cooking,” chimed Harry and Wilma.

For supporting authority, see endnote.

Study 5. (Actual case.)

Willie was a small manufacturer who, back in the eighties, became intrigued with the soldier of fortune life, wheeling and dealing in exotic locales. An Orange County law firm established a foreign non-grantor trust and a trust-owned corporation for him in the Cayman Islands. He then transferred several hundred thousand dollars to the corporation in exchange for a deferred private annuity. Not long after that, he fell into the clutches of a retired dentist holding himself out in hotel seminars as an expert on offshore tax planning. The expert introduced Willie to John, an accountant in Cork, Ireland. The John had an idea: for Willie to purchase *another* private annuity, this time from an Isle of Man corporation owned by John. He did so, sending John more than \$1 million over the next 15 years, including all but about \$100,000 from the Cayman structure.

The difference between these two deals is this:

- On his death, the funds remaining in the Cayman structure pass to his three daughters.
- On his death, the funds remaining in the Isle of Man structure pass to John.

Willie sold his business, married his cute office manager, and retired. The annuity was to begin at his age 65. Age 65 came and went. No annuity. Inquiries to John (telephone, facsimile, e-mail, and two personal visits) led only to pleasant conversations, nice dinners with John and his wife, promises, and no action. With the end of the payments for his business hewing into view, Willie began to choke, showing up on my doorstep after three or four other attorneys failed to recover the funds.

After ploughing through a raft of documents, it became clear that prospects for recovery by litigation was remote: The records were too fragmented to piece together admissible evidence of fraud or abuse.

I made several attempts to persuade John to do the right thing, making no more headway than did Willie and prior counsel. Then, after preparing an agreement rescinding the private annuity with John’s Isle of Man corporation in exchange for his payment of \$1.8 million, I showed up at his office in Cork.

Walking in, I announced that a taxi was at the curb with the motor running, and that we were going to resolve this matter or I would proceed immediately to the barrister’s office. He laughed, and called his receptionist to send the cab away. We discussed the facts and his concerns. I described how I planned to deal with those concerns. He wrote the check, signed the rescission agreement, and we went to his favorite restaurant for lunch.

On the return trip, while I was somewhere over Greenland, John stopped payment on the check.

The funds were to be reconsolidated in the Cayman structure, so the check was payable to the Cayman trustee. When the check bounced, the trustee, the trustee’s bank, and I made many and varied efforts to overcome John’s stalling tactics. He wanted proof that the corporation was duly formed and in existence, proof that it had its own bank account, etc., but no response

satisfied him.

After a few weeks, I advised Willie that, even though we may not be able to put together a case for fraud in the underlying transactions, Irish counsel reported that we have one for the rubber check, plus court costs and attorney fees. I suggested that we sue John on the check, and that we seek to have his accounting license revoked. They agreed, a step requiring real courage, since it meant spending every remaining nickel he owned. On behalf of Willie, I then engaged counsel in Cork to prosecute the two-prong attack.

Once demands were made and ignored, the action was commenced and a complaint was filed with the body in Ireland regulating accountants. As to the latter, the body came down hard on the accountant and – with a few continuances to allow time for more evidence – seemed ready to revoke his license. Before that could happen, the Cork attorney obtained a court order imposing judicial liens on two office buildings owned by John. He then persuaded John's attorney that we had a lay-down hand and that they were going to lose, and lose big. The parties entered into a stipulation for an uncontested judgment for \$2.2 million. One of the buildings was sold, and the judgment paid.

This time the check was payable to Willie. He happily endorsed it over to the Cayman trustee. I took the revised plan documents and the check to Grand Cayman to meet with the director of the trust company and the assigned trust officer, making certain that each aspect of a complicated, tax-intensive, transaction was fully understood, and closed the case.

Willie and his wife followed up with a trip to become personally acquainted with the Cayman trust company staff. Now, at age 69, Willie finally has his annuity producing a tidy and regular income. So, if you see someone on a southern California beach, fully relaxed, Mai Tai in hand, that's our boy.

Study 6. (Actual case.)

Aubrey and Birdie were both 67 years of age. She was a registered nurse running a large assisted living facility, and he was founder and president of a large truck parts distribution company. Their son was taking over the day-to-day operations as Aubrey dialed back his time commitment, when a deal went sour. A customer opened a new operation in another state using equipment assembled for him by Aubrey's company. When the customer found the competition too stiff, he folded his tent and tried to shift his loss to Aubrey's company by fabricating a bogus claim for defective products.

Aubrey and Birdie were contemplating trade winds and soft music, not a lawsuit. So, this news arrived like a cold water enema. Aubrey took action with an aggressive defense, but lost at trial due to mistakes by his defense attorney. He finally worked out a standstill agreement by which payments were made to the customer pending the outcome of a lawsuit by Aubrey's company against the defense firm. There remained a risk, however, that the recovery would be insufficient to cover the remainder of the judgment. If that were to happen, Aubrey would be next in the cross-hairs with an action on his personal guarantee of the standstill agreement.

Any transfer of assets at this time for less than equivalent value could be set aside by a

court in a fraudulent action, so Aubrey and Birdie opted for a foreign private annuity. They collected their non-exempt resources, including borrowing all but a small equity in their home, and purchased a \$1,750,000 inflation-adjusted annuity. Birdie's \$400,000 401k plan is exempt from the claims of judgment creditors, and the plan distributions *remain* exempt when reposing in her bank account. The first-year private annuity payout is slightly over \$130,000, and it increases by 3% per year for their joint life expectancy of 23.7 years before leveling out for the remaining actual lifetime of both or the survivor. Just as important, the purchase is not voidable by the U.S. courts as a fraudulent transfer. That frees Aubrey and Birdie to wrap up their business affairs and retire without fear.

Study 7.

Shirley, a single lady 34 years of age with a BS in computer science, left Microsoft six years ago to co-found a software company. She and her associates had a good concept, found the necessary financing, and sold out a few months ago in a tax-free stock exchange with a public company. Her share was \$20 million. Still ambitious, she wants to diversify from her one-stock holding without forfeiting a fortune to IRS on the gain. She also wants to be liquid enough to conduct a small-scale real estate development business.

The stock is restricted for a few years, meaning any sales must be fed slowly into the market. This has a dampening effect on its block-sale market value. Shirley obtained an independent appraisal of the stock, taking a 15% blockage discount into account. She then exchanges it for a single premium deferred foreign private annuity.

Under the private annuity agreement, Shirley may start the lifetime annuity income on 30 days' notice to the Payor. The IRS-imposed interest rate on which the annuity calculation is based is 6%, so the initial exchange property value of \$17 million grows at that rate until the earlier of the annuity beginning date or Shirley's death. Under the terms of the trust, Shirley may receive portfolio earnings in excess of the IRS-mandated interest rate. Our assumption is 8% net, so the excess 2% over the accumulation rate may be paid to Shirley, and she reports those withdrawals as ordinary income to the extent they exceed the accumulation value of the contract (\$17 million plus accruals at the 6% rate). (Code Section 72(e)) This assumed 2% differential starts at \$340,000 per year, and rises as the portfolio value appreciates: note, however, that the actual payout may be less on these facts because the stock must be fed into the market over a multi-year period, probably paying no dividends in the meantime. Shirley's life expectancy is 48.3 years, so if there is no election to begin the annuity, the exchange property value grows at that (6%) rate to \$278,695,819 at the projected date of death. In the meantime, she has enjoyed a generous cash income increasing throughout her lifetime in a manner avoiding the inroads of inflation. Her estate incurs no wealth transfer taxes, and – as to the exchange property stock – *no capital gain taxes*. Capital gains are reported only if and to the extent allocated to annuity payments, and in this arrangement there are no annuity payments. Just cash distributions from excess portfolio earnings. The \$278 million remaining at her death passes to her foreign trust, where it is held as a family bank assuring all family members first-class educations and opportunities in life. Or it may pass through the trust to a

favorite church or charity. It is all up to Shirley. Whatever her preference, those remaining assets escape gift, estate, and GST tax entirely.

Caution. The structure described at Studies 4, 7, and 8 below are analogies to commercial annuities. There are no IRS rulings or court cases dealing with them. Consequently, it would be prudent to seek a private letter ruling from IRS before using such a structure.

Study 8.

Wanda is a sprightly 84-year-old widow. She has a close and loving family. Her husband, Tom, died 10 years earlier. His death occurred shortly after selling his company, an international private-label cosmetics manufacturer, for \$100 million net. Wanda lives on a grand scale in a large English Tudor home in the Hancock Park section of Los Angeles. She has a maid, a groundskeeper, and a driver, and she spends her summers at her farm house in Deauville, on the Normandy coast of France.

Upon returning from her most recent summer on the continent, her annual physical examination revealed a heart condition. Now, thinking about her mortality for the first time, Wanda asked herself, "What would Tommy do?"

She surmised that he would move heaven and earth to avoid losing more than \$50 million of his hard-earned, already-taxed, money to Uncle Sam for the federal estate tax. Moreover, she remembered an equally horrible one called the GST tax imposed at a flat 55% on top of any gift or estate tax connected with a gift to a grandchild or great-grandchild. She shuddered.

To deal with these concerns without materially imposing on her lifestyle, Wanda exchanged her \$100 million portfolio of securities for a \$100 million single premium deferred foreign private annuity.

As is the case with Shirley (above), the annuity exchange property accumulates at the IRS-imposed rate of 6% and she receives distributions from the excess earnings currently. If the Payor is able to produce a net annual portfolio return of 8%, current distribution of the 2% excess earnings amply funds Wanda's ongoing living expenses, initially at \$2 million annually.

On her death seven years later without exercising her power to start the annuity installments, the entire accumulation of \$150,363,026 passes to a trust for the benefit of her children, grandchildren, and so on for as long as she has living descendants. Her estate incurs no wealth transfer taxes, and no capital gain taxes. (Capital gains are reported only if and to the extent allocated to annuity payments. In this arrangement there are no annuity payments. Just the excess portfolio earnings.)

Fearful of depriving future generations of ambition by making work unnecessary, all generations below her children receive targeted benefits. That is, distributions are

discretionary with the trustee, and the trustee is instructed in the trust agreement to give a priority to vocational and college expenses if such training and education are productively pursued, to a down payment on a first home if the beneficiary has credit good enough to qualify for 60% financing, to provide seed money for a business or professional practice, and to match the earnings of those whose talents and interests are socially valuable but economically unrewarding (*e.g.*, teaching, the ministry, the arts). Signing the trust agreement, she muttered, “. . . and zip for any yo-yo who wants to spend his life on the beach smoking hemp!”

Study 9.

Charlene and Charlie bought a triplex in Glendale, California two years out of graduate school, and for the next 30 years, lived in one unit and rented out the other two. They cocooned themselves with quality upgrades to the owner’s unit, adding a 300 square foot garden room on part of the original patio, enlarging the patio, installing an in-ground spa covered by a pagoda, copper pipes, enclosed eaves, concrete driveway, wood-frame french windows, solid interior doors, ornate crown moldings, upgraded kitchen and bathroom fixtures and appliances. The original cost plus capital improvements came to about \$300,000 over the years. Now, at 55 with a joint life expectancy of 34.4 years, they want to move to Palm Desert and refocus on golf. The home has appreciated in value to \$2.4 million, so Charlene and Charlie are looking at capital gain taxes on the order of \$320,000 (\$2.4 million, less the \$300,000 tax basis, less the \$500,000 profit exclusion under Code Section 121, times 20% state and federal combined tax rate).

Thinking there must be a smarter way to deal with this problem, they obtained an independent appraisal supporting the \$2.4 million value, then exchanged the interest representing the depreciable portion of the property (\$1.6 million) for a single premium immediate foreign private annuity, payable jointly and to the survivor for life. They then joined with the Payor in selling the property.

Treasury Regulation Section 1.121-1(e) requires Charlene and Charles to allocate their \$500,000 profit exclusion to the portion serving as their home, using the same allocation formula in use for depreciating the rental units. They did so, giving them a basis in the home portion of \$ 600,000 (\$300,000 total tax basis, \$100,000 of which is allocated to the owner’s unit, plus \$500,000 representing the Section 121 exclusion). The gain on the rental units was deferred by means of the private annuity.

On closing the sale, \$1.6 million went to the Payors and \$800,000 to Charlene and Charles. Their \$600,000 tax basis led to net after-tax proceeds of \$760,000 (\$800,000 – \$100,000 tax basis, – \$500,000 profit exclusion under Code Section 121, x 20% combined state and federal capital gain tax rates). They used the net cash proceeds to purchase a Palm Desert home, then kicked back to enjoy annuity income of \$117,962 per year payable for as long as either of them lives.

The annuity represents a payout rate of 7.4% ($\$117,962 \div \$1,600,000$). If the payor’s

asset manager is able to earn an 8% net return on the portfolio, the \$1.6 million exchange property value will – on death of the surviving annuitant – have grown to almost \$30 million. Upon dissolution of the Payors and payment of the liquidation distribution to the trust, the children wind up with a substantial family bank to fund better opportunities in life for everyone in the family for the next century or more. That’s after Charlene and Charles have received annuity payments of more than \$4 million.

Study 10.

In study 5 above, the rental property of Charlene and Charles must be allocated to the owner’s unit using the same formula by which depreciation of the rental units are determined. Their unit was one third of the total, thus one-third of the total sale price, and they were able to allocate their \$500,000 profit exclusion to their own unit, along with one-third of the \$300,000 tax basis otherwise existing. One-third of the sale price was \$800,000, so Charlene and Charles received \$800,000 from the sale of the triplex, subtracted \$600,000 (\$500,000 + \$100,000 allocated basis) and reported a \$200,000 gain. Therefore, basis in the two-thirds interest exchanged for the private annuity had a \$200,000 tax basis (\$300,000 – \$100,000), recovered tax-free through the annuity installments. Now, we turn to Ken and Barbie to look at the exchange of a partial interest in a *single*-family residence.

Ken and Barbie saw their \$40,000 bungalow appreciate to \$1 million, and began thinking about returning to Texas. Since in Texas they are able to purchase twice the house for half the money, they asked about swapping part of the ownership for a private annuity, keeping the rest to pay cash for the Texas home. Their attorney ran the numbers as follows:

	Home value	\$1,000,000
	\$500,000 exclusion under <i>IRC</i> Section 121)	600,000
Tax basis (\$40,000 cost, \$60,000 improvements,	Capital gain on sale	400,000

They exchange a 60% interest as tenant in common for a \$600,000 private annuity producing (at their ages 67 and 69) \$41,491 the first year, increasing 3% per year, payable for as long as either of them lives, a total on the order of \$1,232,000.

Treasury Regulation Section 1.121-4(e) *permits* Charlene and Charles to allocate their \$500,000 profit exclusion to the either the portion exchanged for the private annuity or to the retained portion.

The \$100,000 tax basis must be allocated 60/40, leaving them with a \$40,000 basis in the portion retained. They allocate \$360,000 of the Section 121 exclusion to the interest retained, giving them a zero capital gain on sale. They allocate the remaining \$140,000 of the exclusion to the interest exchanged for the annuity, which gives them a tax basis of \$200,000 in the exchanged portion (\$100,000 x 60% plus \$140,000). \$200,000 is recovered tax-free through annuity allocations, and the gain on the exchanged portion was deferred by means of the private annuity.

They receive \$400,000 from home sale to use in purchasing the Texas home. Tax basis in the interest retained is \$400,000, leading to a capital gain of \$-0-.

The tax basis in the portion of the home exchanged for the private annuity is \$200,000 (see above), leading to a capital gain of \$400,000, and a tax of \$80,000. This tax is spread and reported ratably over the next 23 years (starting in a year). Because the \$80,000 they *would have* paid is in the bank earning interest during the ratable recognition of gain time (the annuitant's life expectancy), the "time value of money" analysis eliminates the capital gain taxes altogether, leaving \$2,247 from excess interest earnings on the expected date of death.

To Ken and Barbie, having a debt-free home and an inflation-insulated life income is compelling . . . and free of gift, estate, and GST taxes.

Below is the "time value of money" analysis reducing the impact of the \$80,000 capital gain taxes by deferring payment over the annuitants' joint life expectancy.

Assumptions:

- A 23-year joint life expectancy.
 - An 8% net return on the portfolio established from the exchange property sale.
 - 6% bank interest on the tax that wasn't paid, reduced to 4% by income taxes.

Year	The Cash Interest on	Installment Balance of	Balance
	Sale Tax Balance at	Payment With Private Annuity 4% After-Tax Tax	Cash Sale
		1.	\$80,000
			\$80,000
			\$3,200
			\$83,200
		2.	83,200
	80,708	2,492	3,278
			83,986

3.	83,986	2,567	81,419	3,308	84,727	
4.	84,727	2,644	82,083	3,336	85,419	
					5.	85,419 2,723
						82,696 3,362
						86,058
					6.	86,058 2,805
						83,253 3,442
						86,695
					7.	86,695 2,889
						83,806 3,468
						87,274
					8.	87,274 2,976
						84,298 3,431
						87,729
					9.	87,729 3,065
						84,664 3,448
						88,112
					10.	88,112 3,157
						84,955 3,461
						88,416
					11.	88,416 3,252
						85,164 3,472
						88,636
					12.	88,636 3,350
						85,286 3,478
						88,764
					13.	88,764 3,451
						85,313 3,482
						88,795
					14.	88,795 3,555
						85,240 3,481
						88,721
					15.	88,721 3,662
						85,059 3,476
						88,716
					16.	88,716 3,772
						84,944 3,473
						88,417
					17.	88,417 3,885
						84,532 3,459
						87,991
					18.	87,991 4,002
						83,989 3,440
						87,429
					19.	87,429 4,122

						83,307	3,415
						86,722	
					20.	86,722	4,246
						82,476	3,384
						85,860	
				21.	85,860	4,373	81,487
					3,347	84,834	
22.	84,834	4,504	80,330	3,303		83,633	
23.	83,633	4,639	78,994	3,253		82,247	

Implications: capital gain taxes are *eliminated* by net interest earnings on the money that would have been paid if the gain was recognized in the year of exchange, leaving the original setaside for tax of \$80,000 *untouched*, and accumulated net after-tax interest of \$2,247 (\$82,247 – \$80,000). *That* is the time value of money.

Below is the schedule of inflation-adjusted annuity payments over the joint life expectancy of Ken and Barbie, with the principal balance adjustments for projected return on the portfolio constructed from the house sale proceeds.

Assumptions:

- A 23-year joint life expectancy.
- An 8% net return on the portfolio established from the exchange property sale.
 - 3% annual increases in the annuity payments, leveling after the 23rd year.

The adjusted principal balance of the exchange property is in the second column, the annual annuity installments in the third column, and the assumed portfolio earnings in the fourth column. As to the earnings, I subtracted one-half the annuity payment from the adjusted balance in the second column in order to reflect a rough average balance for the year before applying the 8% return calculation.

The adjusted principal balance of the exchange property is in the second column, the annual annuity installments in the third column, and the assumed portfolio earnings in the fourth column. As to the earnings, I subtracted one-half the annuity payment from the adjusted balance in the second column in order to reflect a rough average balance for the year before applying the 8% return calculation.

Year	Balance	Adjusted Portfolio
Adjusted Bal.	First of Year	Annuity Earnings
End of Year		
		1. \$600,000
	\$41,491	\$46,340
		\$604,849
		2. 604,849
	42,736	46,678
		608,791
		3. 608,791

				44,018	46,943	
				611,716		
4.	611,716	45,339	47,124	613,501		
5.	613,501	46,699	47,212	614,014		
6.	614,014	48,100	47,197	613,111		
7.	613,111	49,543	47,067	610,725		
8.	610,725	51,029	46,817	606,513		
9.	606,513	52,560	46,419	600,372		
10.	600,372	54,137	45,864	592,099		
11.	592,099	55,761	45,137	581,475		
12.	581,475	57,434	44,221	568,262		
13.	568,262	59,157	43,095	552,200		
14.	552,200	60,932	41,739	533,007		
15.	533,007	62,760	40,130	510,377		
16.	510,377	64,643	38,245	483,979		
17.	483,979	66,582	36,055	453,452		
18.	453,452	68,579	33,533	418,406		
				19.	418,406	70,533
					30,651	378,524
				20.	378,524	72,649
					27,376	333,251
				21.	333,251	74,828
					23,667	282,090
				22.	282,090	77,073
					19,484	224,501
				23.	224,501	79,385
					14,785	159,901

There is no way a domestic private annuity can net an after-tax return high enough to avoid outliving the money. But by placing the Payors in a no-tax jurisdiction with the foreign private annuity, that risk is minimized.

Keep in mind, however, that establishing an offshore structure for the private annuity is a complex undertaking. It should not be attempted without associating experienced counsel or committing substantial time in developing a full grasp of the law and strategies. The professional must reverse-engineer Code Sections 679 and 684 (to avoid grantor trust classification), must understand and neutralize the effects of the *Foreign Investment in Real Property Act* (treatment of the U.S. real property as “effectively connected with a U.S. trade or business”), avoid the reach of the (30% flat) U.S. branch profits tax, and properly advise the client on tax reporting for the transaction.

Conclusion

The domestic private annuity, including the form popularly referred to as The Private Annuity Trust, simply do not stand up to close scrutiny. The clients are sure to lose money, and could lose much more defending the transaction from attack by the IRS.

The foreign private annuity neutralizes the primary weaknesses of its domestic cousin: risk of losing the exchange property to the payor’s creditors; risk of losing the annuity income to the annuitant’s creditors; and forced principal invasions due to income taxes imposed on the Payors. It’s not simple, but the capital gain toll charge is modest at 15%, and the long term results are dramatic.

Endnote