

Excerpt From: Private Annuities and the Foreign Non-Grantor Trust

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The private annuity as a financial planning tool has surfaced and resurfaced periodically over the past half-century. Its functions include:

- _ moving assets out of the Annuitant's estate and away from the tax man, while retaining an income;
- _ spreading capital gains over the remaining lifetime of the Annuitant when exchanging appreciated property for the annuity; and
- _ delivering the appreciated property to the Payor with a new basis permitting its immediate sale without capital gains taxation.

Our focus here is to understand the private annuity, to examine its use in a variety of circumstances, and to consider its combination with a foreign non-grantor trust. Used artfully, it may be our most powerful weapon for controlling wealth transfer taxes.

The Private Annuity

A private annuity is an agreement between two parties, neither of whom (or which) is in the business of *issuing* annuities. Under the agreement, one party (Annuitant) transfers property to the other (Payor) in exchange for the Payor's promise to make periodic payments in specific amounts to the Annuitant, typically for the Annuitant's lifetime.

Characteristics. Here are the elements that define the private annuity:

- _ The agreement establishes the Annuitant as a general creditor of the Payor.¹
- _ The parties are usually individuals who are related to each other, although other relationships are permitted. It could be between a corporation and an individual, or between a trust and an individual, or between an estate and a corporation (with the estate exchanging property or stock for payments by the corporation measured by the life of an estate beneficiary); or between a corporation and a retiring shareholder under a stock redemption arrangement, with annuity installments in lieu of the more usual lump-sum payment.
- _ The Payor must not be a person who is engaged in the business of issuing annuity contracts, even occasionally. If so, the difference between the present value of the annuity² and the Annuitant's basis in the property is immediately taxable.³ As you will see, one advantage of a private annuity is that taxation of this gain may be spread over the Annuitant's life expectancy.
- _ As soon as the private annuity agreement is executed, the Payor acquires legal title to the transferred property and may sell or otherwise dispose of it as desired. The Annuitant could

Page 13 The purchase of a private annuity is not a fraudulent transfer, in and of itself. It is the purchase of an asset for full fair market value. The creditor will ordinarily have to go to the country where the trust is located, there to attempt reducing the claim to judgment a *second* time.³⁴

Illustrations

Example 1. Let us assume a husband age 69 and a wife age 67. They own a \$2 million apartment house with an adjusted basis of \$400,000. 120% of the applicable federal rate is 7% \$10,000 of GSTT exemption is allocated to the trust to cover the seed money. The Payor-foreign corporation will sell the apartment house for cash and invest the proceeds at a 10% total annual rate of return. The form of annuity is single premium immediate, payable jointly and to the survivor for life. Their joint life expectancy is 22.4 years. We will assume that the survivor dies in mid-year, requiring an 18-month delay in dissolving the corporation and distributing its assets to the trust. Here is how it plays out:

The annuity amount is \$190,979 a year. Of that amount, \$17,857 is tax-free recovery of basis, \$71,429 is capital gain, and \$101,693 is ordinary income.

The investment income of \$200,000 reduced by the annuity installments of \$190,979, leaves about \$9,000 each year to accumulate at the 10% rate. That excess grows to \$835,000 at death of the surviving spouse.

The foreign non-grantor trust then receives a liquidating distribution from the corporation of \$2,835,000 (excess accumulation, plus the annuity principal because the annuity obligation was funded entirely from investment income). There, it is held, managed and administered for the benefit of the children, and all of this *after* the husband and wife have collected \$4,277,930 in annuity installments!

Not a *dime* of the \$2 million *or* the excess accumulation is included in their gross estate. There is no gift tax. No GSTT is incurred as the trust benefits pass from generation to generation for as long as the husband and wife have any living descendants.

Example 2. Younger lives and deferral periods lead to some *eye-popping* results. Here is how it might work for one of the dot-com kids with their big stock options. .

Assume a single female age 30. She owns qualified stock options worth \$1 million, zero basis, and subject to state and federal long-term capital gain taxes of \$300,000 if she sells them. She wants to retire or cut back around age 50. Again, 120% of the applicable federal rate is 7% \$10,000 of GSTT exemption is allocated. The Payor will sell the options for cash and invest the proceeds at a 10% total annual rate of return. The form of annuity is single premium deferred,