

Financial Planning

A Private Annuity Surprise

Treasury unexpectedly releases regulations intended to close the loop on private annuity trusts

By Scott P. Borsack

Generally, there are no great secrets in the world of tax and estate planning. We all usually get some hint of things to come before they actually arrive. The Internal Revenue Service (IRS) tells us of regulation projects through its business plan months in advance of the release of regulations. Representatives from Treasury hit the seminar circuit to tell us of abuses before any action is taken. It is because of this general backdrop that so many were surprised when on October 17, Treasury released regulations intended to close the loop on so-called private annuity trusts.

A private annuity trust promoter was quoted in an article in the *Wall Street Journal* to be “scrambling” as the result of the release of the proposed regulations, which he said was a “shocker.” Silverman, “IRS Aims to Limit a Deferral Strategy,” *Wall Street Journal*, October

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17, 2006. Someone whose livelihood depends upon the availability of this strategy had no warning. So the rest of us were no less surprised. Now we have to deal with the potential fallout.

In a private annuity trust transaction, a member of the senior generation of a family sells a highly appreciated asset to a nongrantor trust in exchange for a promise by the trust to pay the seller a lifetime annuity. The promise is usually unsecured. Based upon some old precedent and a 37-year-old Revenue Ruling, taxpayers using this strategy have not reported any gain from the exchange. Rather, gain is usually deferred until the sum of annual annuity payments exceeds the taxpayer's basis in the property surrendered, at which time all future payments are treated as taxable income. Apparently the IRS must have come across a rash of private annuity transactions to take the extraordinary step of releasing surprise regulations. Maybe published articles led the IRS to conclude that reliance upon its ruling and court opinions could lead to widespread abuse. Whatever the motivation, Treasury has attempted to use the regulatory process to change legal precedent.

Treasury apparently believes that taxpayers are now using the annuity rules to circumvent federal income tax laws. The annuity rules of Code Section 72 have been around for a while. Basically, where a taxpayer purchases an annuity, income is recognized each year on the receipt of

each payment under the contract. A portion of each annuity payment is considered a return of capital and the excess is treated as income. The return of capital portion is determined by multiplying each payment by a fraction, whose numerator is the taxpayer's investment in the contract and the denominator is the sum of the expected payments under the contract. Code Section 72(b)(1). This works well where an unrelated third party in the business of offering annuities for sale is the issuer. Things begin to break down where the issuer and the annuitant are related.

That taxpayers are using court opinions and IRS pronouncements to reduce their income tax exposure should not come as news to anyone. The trend apparently started with *Lloyd v. Commissioner*, 33 BTA 903 (1936), where the court found that an annuity contract had no fair market value under the predecessor to Code Section 1001(b) because of the uncertainty of payments from the issuer of the contract, in that case the annuitant's son. The court reasoned that since a private party was obligated to make annual payments for life, and was not subject to the regulations which police financial institutions engaged in the business of offering annuities commercially, there were significant and material risks inherent in the annuity. Furthermore, the promise to make these payments was unsecured. Where the value of that which is received cannot be determined, gain is not reported until the taxpayer recovers

his basis. This was the so-called open transaction doctrine which was framed by the Court in *Burnett v. Logan*, 283 U.S. 404 (1931). On these facts, income recognition was deferred to a later year. Initially, the IRS did not acquiesce in this opinion, but ultimately changed its position and accepted the holding. XV-2 C.B. 39 (1936) later withdrawn by 1950-2 C.B. 3.

Unlike *Lloyd*, in *Estate of Bell v. Commissioner*, 60 T.C. 469 (1973), the annuitant received a secured promise to make annual annuity payments. Here the property transferred was held in escrow together with a cognovit judgment against the payor of the annuity. Since the petitioner was protected by an abundance of security for the payment of future obligations, the open transaction doctrine which *Lloyd* applied to annuity transactions could not be applied here. The property delivered had a market value in excess of the value of the annuity, which excess the court noted should be treated as a taxable gift. The petitioner argued that the annuity should have the same value as the cost of purchasing an annuity from a commercial issuer. The Commissioner argued that its mortality tables should be used to value the annuity. Since commercial annuities include a profit for the issuer, the court found that the Commissioner's tables more accurately reflected the value of the private annuity issued here. As such, the Commissioner's valuation argument was sustained.

An early entry by the IRS into this fray came in the form of Rev. Rul. 69-74, 1969-1 C.B. 43, which dealt with a classic private annuity situation without any mention of the receipt of adequate security. The IRS looked at two questions — how much gain was realized on the exchange of appreciated property for the annuity, and when income would be recognized. The IRS first looked at the value of the annuity and the value of the property surrendered to determine the potential for gain or gift recognition on the exchange. If the transfer was between family members, the difference would be treated as a gift, and if between unrelated parties, the difference would be treated as taxable gain. The value

of the annuity was determined with reference to the Commissioner's mortality tables. As for the recognition of annual income, the exclusion ratio of Code Section 72 was utilized. No mention was made of the open transaction doctrine or whether the annuity obligation was secured.

With the opinion of the court in *212 Corp. v. Commissioner*, 70 T.C. 788 (1978), all seemed to be status quo in the private annuity world. First the court noted that where parties are not dealing at arm's length, as in the case of an intrafamily sale, the excess of the value of property surrendered over the value of the annuity would be treated as a gift by the annuitant. Furthermore, in the gift context, the investment of the annuitant in the contract is limited to the value of the annuity. Investment in the contract is relevant to determine the amount of income recognized each year as payments are received. As was the case in *Estate of Bell*, the court found that the Commissioner's tables should be used to determine the value of an annuity. Since the annuity obligation was adequately secured, the open transaction doctrine of *Burnett v. Logan* was not applied. Annual income was recognized with reference to the rules provided by Code Section 72.

Upon this canvas taxpayers and their advisors created the private annuity trust technique. Relying upon prior precedent, annuities offered by these trusts were not secured. As such the open transaction doctrine dictated that there would be no income recognized on the exchange. Presumably a trustee would argue that basis in the property equaled its market value because of the exchange, effectively stepping up basis. As such, the sale of the property at market value would not yield any taxable income. The trustee could then invest the proceeds from the sale, undiminished by income taxes in a commercial annuity, for example. Something changed recently to lead the IRS to conclude that this was abusive. It only took 37 years for the IRS to come to this conclusion. Enter the proposed regulations.

The proposed regulations do a couple of things. First, they seek to reverse the

course of judicial precedent by eliminating the difference between secured and unsecured annuities, treating all annuities as if they were secured. Recall that *Lloyd* created a tax advantage for the unsecured annuity — income would not be recognized until basis was recovered. The proposed regulations provide that where an annuity is exchanged for property, the amount realized from the disposition is the fair market value of the annuity contract, determined under Code Section 7520, Prop. Regs. 1.1.1001-1(j), regardless of the presence or absence of security. The open transaction doctrine has no place in the determination of annuity income, says the IRS, whether upon the exchange or during the life of the annuity. Therefore, unsecured annuities are treated in the same manner as secured annuities.

Regarding the recognition of income from the receipt of annuity payments, Prop. Regs. 1.72(e)(1) provides that the amount deemed to have been paid for the contract equals the amount realized on the exchange. The amount realized on the exchange is the fair market value of the contract. The exclusion ratio in the case of the issuance of an annuity for property is computed as the fair market value of the annuity contract over the total payments anticipated under the contract. Again, market value of the annuity contract is determined under Code Section 7520. This seems to be in line with court precedent.

By placing the language in Treas. Regs. 1.1001-1, Treasury has made it clear that the exchange of property for an annuity creates the potential for the recognition of taxable income or a gift on the exchange. If the fair market value of the annuity is greater than the annuitant's adjusted basis in the property surrendered, the annuitant will report taxable gain on the exchange if the transfer is to an unrelated party, or a gift in the related party transaction. Treasury has announced that by implementing this rule, it is their intention to place an annuitant who receives an annuity in exchange for property in the same position as an annuitant who first sells his property and uses the cash from the transaction, net of income taxes, to

then purchase an annuity.

The proposed regulations also contain some nifty effective date provisions. First, the rules apply to all transactions entered into after October 18. Prop. Regs. 1.1001-1(j)(2)(i). An exception is provided for those transactions where the issuer of an annuity is an individual, the property which is exchanged for the annuity is held by the annuity issuer for at least two years and the annuity is not secured. For described transactions, the effective date is April 18, 2007. Prop. Regs. 1.1001-1(j)(2)(ii). Secured annuities are excluded from the extended effective date because the proposed regulations do not offer any changes to the jurisprudence regarding secured annuities. It is only for the unsecured annuities that new ground is broken. It should be noted here that a transfer by the annuity issuer to a grantor trust is treated as a disposition of the underlying property which would take the transaction outside of the exception provided for the extended effective date. Prop. Regs. 1.1001-1(j)(2)(ii)(C).

I never subscribed to the open transaction doctrine in connection with the

issuance of private annuities. Rather than use the private annuity trust and rely on *Burnett v. Logan*, it has been my practice instead to create an intentionally defective grantor trust (IDGT) and sell the appreciated assets to the IDGT in exchange for a private annuity. In these transactions the annuity was always unsecured and the IDGT was seeded with a few dollars to at least provide an argument that the assets sold were not the only assets available to fund the annuity. If the open transaction doctrine were viable, two arguments against immediate taxation would be available — the grantor trust rules and the position articulated in *Lloyd*. So in my practice, the issuance of these regulations, in proposed or final form, do not present too much of a problem.

It will be only a matter of time before a taxpayer challenges the regulation, arguing that the application of the open transaction doctrine by *Lloyd* was appropriate and that Treasury was overreaching. The real concern lies with the coupling of the private annuity with an IDGT as described above. It might be only a matter of time before the IRS attempts to

challenge those transactions as well. I would like to think, however, that the IRS will not take that extra step.

Recall that the final step of the private annuity trust is the sale of the property which it received in the annuity exchange. Trustees have taken the position that basis in the exchanged property equals the market value of the annuity. As such, the trustee is benefited by a step-up in the basis of the property. The sale of the property by the trustee would not yield any taxable income. Unlike the private annuity trust, if an IDGT were to dispose of property which it received from the grantor, gain would be recognized. The basis of the trust in the property it receives from the grantor carries over from the grantor — the gain potential in the hands of the grantor is preserved. A sale by the trust results in the recognition of taxable income. The IDGT does not present the same potential for abuse as the private annuity trust. Hopefully, the IRS will stop with the proposed regulation and not throw the baby out with the bathwater, recognizing the difference between the techniques. ■