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Tax Incidents of Private Annuities

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TAX INCIDENTS OF PRIVATE ANNUITIES

*by Professor Richard L. Grant**

ONE CAN BEST DESCRIBE a private annuity by stating what it is *not*: It is not purchased from a commercial underwriter, but from a person, who, in the ordinary course of his business, does not write annuity contracts. It does not contain a secured promise to perform. In all other respects, the private annuity resembles commercial annuities in that the annuitant transfers cash or other property in exchange for a promise of the transferee (obligor) to make periodic payments of money either for a term of years or for the life of the annuitant. One writer[1] would fragment such a purchase into two transactions—a sale of property and the purchase of an annuity. However, there seems to be no particular tax advantage in characterizing a private annuity in this manner.

While the use of an annuity by an estate planner may involve certain tax savings under the Internal Revenue Code,[2] one must be careful to cast the terms of the contract in an "annuity" form. Thus, even though an arrangement may be denominated an annuity, a *trust* may in fact have been created. In *C.I.R. v. Kann's Estate*,[3] a mother "sold" securities to eight children in return for their unsecured promises to pay life annuities to her. The dissenting judge argued that the decedent only passed *legal* title to the securities, reserving a life estate in the income and a power to invade the corpus.

Similarly, one court has been quick to seize upon the use of words other than "annuity" in the agreement. In *Gillespie v. C.I.R.*,[4] the taxpayer made an agreement providing for payments to him in the amount of "$15,000 for life plus $10,000 in dividends." While the court acknowledged that it was possible that the dividend was an annuity, the case indicates that the use of the

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1 Farmer, *Private Annuities*, 101 Trusts & Estates 28 (1962).

2 Int. Rev. Code of 1954 § 72 (hereinafter cited as I.R.C.).

3 174 F.2d 357, 360 (3d Cir. 1949).

4 128 F.2d 140 (9th Cir. 1942).

term "dividend" in the contract can be a ground for excluding such amounts from annuity treatment with the consequence that all such amounts received (less the dividend exclusion) will be includible in gross income.

In order to avoid any misinterpretation of the agreement, one writer suggests that:

> . . . the instruments evidencing the agreement ought to spell out in detail the intent of the parties that there is contemplated an annuity venture. The agreed market value of the property transferred, the interest rate, and the estimated life expectancy should all be made explicitly a part of the contract.[5]

Uses of Private Annuity

One of the major uses of the private annuity is to preserve family control over a closely-held corporation. One family member simply transfers his shares to one or more other family members in return for a private annuity contract.

Moreover, corporations have used the private annuity in the sale of an interest to key employees, or to creditors.[6] A redemption of stock by the corporation is also used where the annuitant and the obligor are the shareholders of the corporation.[7] The net effect of the redemption in a closely-held corporation is similar to the operation of a family annuity, except that in this instance the corporation is the obligor. The courts will disregard the fact that a corporation may not be authorized to enter into an annuity agreement; payments received under such a contract are deemed to be annuity agreements for tax purposes.[8] Similarly, the sale of a partnership interest has been effected through the use of a private annuity.[9] In one case a widow released her dower interest in return for a private annuity.[10]

An intriguing use of the private annuity occurs in the typical two-part trust situation—marital deduction trust for the wife; residuary trust for the children. The wife can renounce her inter-

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5 Galvin, *Income Tax Consequences of Agreements Involving Noncommercial Annuities,* 29 Tex. L. Rev. 469, 508 (1951).

6 Middleditch, *Private Annuity: A Way to Cut Estate Costs, Defer Gain, Get Annuity Tax Benefits,* 24 J. Taxation 164 (1966).

7 Cohen, *Recent Developments in the Taxation of Private Annuities,* 16 U.S.C. Tax Institute 510 (1964).

8 *Gillespie v. C.I.R., supra* n. 4 at 143.

9 *Autenreith v. C.I.R.,* 115 F.2d 856 (3d Cir. 1940).

10 *Robert Hoe Estate Co., Inc. v. C.I.R.,* 85 F.2d 4 (2d Cir. 1936).

est in the marital trust in exchange for a promise of the trust (the marital trust now merges with the residuary trust) to issue her a private annuity. The advantage is twofold: [11] The assets are removed from the gross estate of the wife; the income which she can expect to receive will be increased.[12]

While the above are some of the uses which have been made of the private annuity, the basic decision whether or not to use this arrangement should, in large part, depend on the following tax considerations.

Basis of the Annuity

One problem which is common to the income and gift tax consequences of using a private annuity is the computation of its basis.[13] The major battle in litigation thus far reported is whether there is a distinction in *value* between private and commercial annuities. If there is such a distinction, then *a fortiori* the basis must be different.

The Internal Revenue Service has taken the position[14] that private annuities are *less* valuable than annuities available from commercial life insurance companies. Accordingly, the regulations[15] contain different valuations for these two kinds of annuities, the private annuity valuations being less. One writer criticizes the use of these tables, since they are based upon 1939-1941 life expectancy tables, which are ". . . obsolete under modern day conditions." [16] Taxpayers, on the other hand, argue that the basis of these annuities ought to be the cost of a comparable annuity from a commercial insurance company. As of late, this latter position has not met with success.

In *Bowden v. C.I.R.*,[17] where a trust for three individuals

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[11] See McGiveran & Lynch, *Private Annuity Plans are Practical Now as Tax Treatment Grows More Certain*, 10 J. Taxation 322 (1959).

[12] The value of an annuity based upon the life expectancy of an older person will be greater than the rate of return earned on the trust assets in the open market.

[13] This is important for income tax purposes in order to compute the exclusion ratio; the excess of the value over the basis of the assets transferred will be a gift, which is important for gift tax purposes.

[14] Rev. Rul. 55-119 (1955-1 Cum. Bull. 352).

[15] Compare private annuity tables (Treas. Reg. 20.2031-7(a) for estate tax, Treas. Reg. 25.2513-5(a) for gift tax) with valuations for commercial annuities (Treas. Reg. 20.2031-8(a) for estate tax, Treas. Reg. 25.2512-6(a) for gift tax).

[16] Cohen, *supra* n. 7, at 505.

[17] 234 F.2d 937, 940 (5th Cir. 1956).

was created with monthly payments of $400 to each for life, the court noted that in valuing the remainder for gift tax purposes "the taxpayer takes for granted that investment yields under the management of a trustee would be the same as that produced by an insurance company." While the taxpayers failed to introduce evidence as to the cost of an annuity from an insurance company, the court indicated that such evidence would not necessarily be determinative. This would imply that a private annuity should carry a lower basis.

In a very recent case,[18] moreover, the court adopted the approach earlier established by the Internal Revenue Service.[19] The taxpayer, who was 79 years of age and in good health, transferred securities with a fair market value of $162,689 to her three children in return for their promise to pay her $22,452 annually (semi-annual installments). Upon receipt of the securities, the children sold 79% of them, and the court held that their basis for determining gain on the sale was determined by the present value of the prospective life payments according to the Estate and Gift Tax Regulations. The court gave the following reasons for refusing to allow the higher basis that would have been produced by using the commercial annuity tables:

> . . . (I)nsurance companies have large assets, . . . they are subject to state regulation on investments and on the maintenance of reserves, and . . . insurance company annuity prices contain a loading factor for anticipated expenses and expected profits. In addition, the insurance companies set prices based on mortality tables reflecting their experience with annuitants as a class. This experience demonstrates that persons who purchase life annuities from insurance companies are a self-selected group who live longer than the general population. The fact that an insurance company refers to mortality tables reflecting longer lives over which payments must be made would, of course, be reflected in higher prices charged for life annuities.[20]

While it may be true that the greater spreading of risks available to insurance companies (which results in a better average performance) may warrant a higher cost for their annuity

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[18] *John C. W. Dix*, 46 T.C. 796 (1966), *acq.*, 1967-1 CUM. BULL. 2 (limited to the finding that the present value of an annuity promised to be paid by petitioners should be adjusted to reflect payment in semiannual installments), *appeal dismissed nolle pros.*, 4 CCH 1968 STAND. FED. TAX REP. ¶ 4516.762 (2d Cir.), *appeal docketed*, 7 CCH 1968 STAND. FED. TAX REP. ¶ 4470 (4th Cir).

[19] See n. 14 *supra*.

[20] *John C. W. Dix*, *supra*, n. 18 at 802.

contracts, the court ignores the fact that the individual *might* equal or even outperform the experience of the insurance companies. Because the aggregate of individuals may not equal the performance of the insured group, some individuals are penalized. While this may not be a just result in some individual cases, it probably is a fair result because it would be impossible to predict beforehand which individual performances will equal the insured group results.

Perhaps an alternative would be to use the fair market value of the transferred property as the basis of the annuity.[21] Such a provision, however, would encourage taxpayers to transfer appreciated property, and the Internal Revenue Service would not likely acquiesce to any transfers which would reduce a gain on a sale through a higher basis.

Finally, in the event of the premature death of the annuitant,[22] the obligor who has retained the property incurs no gain, although his basis will be only the amount of payments made.[23]

Income Tax Consequences

—*To Annuitant.* At the time that the transfer is made no tax is immediately incurred by the transferor if a gain occurs, since the unsecured promise of an individual who is not engaged in the business of writing annuities has no value for tax purposes.[24] The tax is postponed. According to *Burnett v. Logan,*[25] when the number of payments to be made is indefinite, the taxpayer is allowed to postpone the tax until the full amount of his capital has been recovered. However, when Congress enacted the annuity provision, it allowed the annuitant to exclude from his gross income an amount of each payment ". . . which bears the same ratio to such amount as the investment in the contract . . . bears to the expected return under the contract. . . .[26] Thus,

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[21] See Ekman, *Private Annuities: an Attractive but Still Hazardous Planning Device,* 15 J. TAXATION 143 (1961).

[22] For a discussion of the consequences resulting from the premature death of the obligor, see ESTATE TAX CONSEQUENCES, *infra.*

[23] See Middleditch, *supra* n. 6 at 163.

[24] *Burnet v. Logan,* 283 U.S. 404 (1931). See *J. Darsie Lloyd,* 33 B.T.A. 903 (1936); *Kann's Estate, supra; Hill's Estate v. Maloney,* 58 F.Supp. 164 (D.C. N.J. 1945). In *Burnet v. Logan,* the taxpayer transferred securities for cash and an agreement that the obligor pay him 60¢ per ton of ore produced for an indefinite period of time.

[25] *Supra* n. 24.

[26] I.R.C. § 72(b).

even though the taxpayer is taxed at the time of payment, he can only exclude a portion of the payment. The remainder is includible in gross income.[27]

It would seem that the taxpayer could gain a greater income tax advantage by *avoiding* the provisions of Section 72 and structuring the arrangement after that in *Burnet v. Logan, supra* —*i.e.*, an indefinite series of installments.[28] There would be no tax until the entire investment in the contract has been returned. There is one practical drawback to this suggestion, however, namely, that an annuitant would no doubt be hesitant about giving the obligor the unrestricted right to determine the number of annuity payments.

Under either approach, the promise to pay must be unsecured in order to enjoy tax postponement.[29] A secured promise would involve a degree of certainty that the annuitant will receive something, and the recognition of income is proper in that circumstance. One writer has suggested obtaining insurance on the obligor's life in order ". . . to reduce the risk of the obligor's premature death." [30] If the annuitant procures such insurance, the annuity might have the flavor of "security," thus forfeiting the tax postponement. Of course, it is entirely possible that the insured (obligor) might live beyond the term of the annuity without making any of the annuity payments. At the point of expiration of the annuity contract, it is doubtful whether an insurable interest would exist. Thus, insurance law does not provide a completely satisfactory answer.

The annuity contract may provide for a cash down payment. The tax consequence of this is that the down payment will not be an installment under the annuity contract. In *Hill's Estate v.*

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[27] For example, a person 64 years of age with a life expectancy of 18.9 years takes stock with a basis of $100,000 and a fair market value of $400,000 and purchases an annuity for life of $40,389 (annually):

$$\text{Exclusion ratio} = \frac{\text{investment in contract}}{\text{expected return}} \times \text{annuity payment}$$

$$= \frac{\$400{,}000}{\$40{,}389 \times 18.9} \times \$40{,}389$$

$$= \$21{,}164$$

Ordinary income amounts to $19,225 (40,389 — 21,164 = 19,225).

Return of capital amounts to $21,164, until the basis is recovered, which is 4+ years. The remaining $300,000 is taxed at capital gains rates for about 13 years. See Middleditch *supra* n. 6 at 161.

[28] See Galvin, *supra* n. 5 at 508.

[29] See n. 24 *supra*.

[30] Middleditch, *supra* n. 6 at 165.

Maloney,[31] where the decedent transferred stock to a syndicate (which included his sons) in return for a $27,000 down payment and the balance in the form of an annuity for life, the court stated that the down payment was ". . . part of the purchase price of the stock and must be considered a return of capital and cannot be considered as income under the annuity contract." If the down payment exceeds the adjusted basis of the assets transferred, then a tax is due immediately, and the advantage of postponement is lost. Of course the matter of using a down payment is subject to negotiation. The obligor may not want to have such a large initial outlay if his financial condition depends on this particular transaction.

There are a variety of other factors which an annuitant should consider. First, in a transfer of appreciated property the capital gains tax is postponed; however, any loss which results from the transfer of depreciated property is not deductible. *Evans v. Rothensies*.[32] In order to get the loss recognized, the taxpayer must first sell the property in the market (where he can realize the loss) and then buy the annuity with the money obtained therefrom.[33] However, a great many private annuities are actually "family annuities," and the sale of the asset is the very thing which the annuitant does not desire—the main purpose being to keep the asset within the family. Furthermore, the taxpayer may be unable to sell the property in order to realize the loss, due to a thin market. He may also be unable to repurchase the property because of the "wash sale" provision.[34]

Second, the annuitant may attempt to effect a private annuity arrangement in the form of a trust for a charity or other tax-exempt organization. This involves transferring assets to a trustee, who then sells them and invests the proceeds in tax-exempt securities, paying the income therefrom to the annuitant for life, and then transferring the principal to the charity as the remainderman. The Internal Revenue Service has taken the position[35] that there will be a capital gain due from the sale or exchange of appreciated property by such a trustee. The theory behind the ruling is that the annuitant actually gave the trustee

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[31] See n. 24 *supra*.

[32] 114 F.2d 958 (3rd Cir. 1940).

[33] See Middleditch, *supra* n. 6, at 160.

[34] I.R.C. § 1091. Note also that § 269, which deals with acquisitions made to evade or avoid income tax, would be inapplicable if a corporation were not making the sale.

[35] Rev. Ruling 60-370 (1960-2 CUM. BULL. at 203).

the proceeds from the sale of the appreciated property, a fiction at most.

To date this ruling has not been challenged; however, there would appear to be two grounds upon which it might be attacked. The first is simply to argue that there was no sale or exchange when the assets were transferred to the trust. A "sale or exchange" is not defined in the statute;[36] therefore, the courts would have to interpret the phrase. With respect to the cash basis taxpayer, the Internal Revenue Service would have to take the position that the sale is taxable because he had received the full amount of the proceeds; the taxpayer has in fact received only an annuity contract.

Alternatively, even if there was a sale or exchange, the taxpayer can argue that the statute must control over a conflicting regulation. Although the taxpayer is given capital gains treatment, the timing of the tax is objectionable. The imposition of the tax at the time of the transfer clearly conflicts with the intent of Congress under the annuity provision[37]—to grant an exclusion of part of the receipts of an annuity payment.

In *Commissioner v. Brown*,[38] the taxpayer and members of his family, who owned substantially all of a lumber milling company, sold their stock to a tax-exempt charitable organization for \$1.3 million, which made a \$5,000 down payment. The company was liquidated, and the assets were leased to a new corporation, which agreed to pay 80% of the operating profits to the charitable organization, which promised to pay 90% of such payments (amounting to 72% of total net profits) to the taxpayer, who held a \$1.3 million noninterest-bearing note. The taxpayer showed the payments as a capital gain.

The court agreed that this was a capital gain, since there was good faith bargaining at arm's length between the taxpayer and the charity and hence a bona fide sale. The test applied by the Court was whether the price paid was excessive. The Court stated that:

> [I]f the seller continues to bear all the risk and the buyer none, the seller must be collecting a price for his risk-bearing in the form of an interest in future earnings over

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[36] I.R.C. § 1223(3).

[37] See n. 2 *supra*.

[38] 380 U.S. 563 (1965).

> and above what would be the fair market value of the property.[39]

Thus, if the price paid was excessive, there is no sale. Of course this is dictum, because in the *Brown* case the Court found that the price paid was a reasonable one.

The significance of the *Brown* decision for a private annuitant is the implication that he cannot deny that a sale has occurred unless the price paid was excessive. The price is considered excessive only if the obligor pays a price exceeding the value of the property received for the promised annuity payments (and in this instance he incurs a gift tax liability).

Of course the Court's dictum suggested that there might not be a sale if there is no shifting of risk. However, the taxpayer might hesitate to show that he has retained a string on the property for fear that it might be included in his gross estate. In any event, the taxpayer could use the *Brown* dictum to show that there was no sale.

Third, in the family annuity contract, once the amount of the annuity has been determined, there can be no later voluntary increases in the amount of the annuity.[40] Thus, if the obligor decides to supplement the annuitant's payments, any such supplements will be received as ordinary income.

—To Obligor

One of the major tax consequences to the obligor is that he cannot take a deduction for interest when he makes the annuity payment.[41] The theory supporting the denial of a deduction is that the obligor is really purchasing the property transferred to him and the amounts paid under the annuity contract constitute the purchase price. Obviously, one cannot deduct that which is a capital expenditure.[42] The effect of this position is that the obligor must pay for these assets with "after-tax" dollars. Offsetting this disadvantage is the fact that usually the obligor has obtained the assets without a down payment, and given a suffi-

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[39] *Id.* at 573.

[40] Treas. Reg. 1.72-4(a)(3) (1956).

[41] A provision to allow the deduction was included as § 1241 of the House Bill on the 1954 Code but was deleted in the Senate version. See H. R. 8300, 83d Cong., 2d Sess. § 1241 (1954). The treasury takes the position that no deduction is allowed. See REV. RUL. 55-119, *supra* at n. 14.

[42] See *Edwin M. Klein*, 31 B.T.A. 910, 918, *aff'd* 84 F.2d 310 (7th Cir. 1936).

cient rate of return, the assets can produce enough income to be self-liquidating, *i.e.,* pay off the annuity.

In addition, where the assets transferred to the obligor are depreciable, he can recover his cost through the depreciation deduction.[43] His basis for computing depreciation is the amount of payments actually made; thus, if the annuitant reaches his life expectancy the basis for the assets will be what the obligor calculated them to be. The obligor assumes the risk of a premature death by the annuitant, which would decrease his expected basis.

If the obligor sells the assets before the annuitant dies and at the time of the sale the proceeds exceed the basis (payments made), gain is recognized. Similarly, a loss is recognizable if the proceeds of the sale are less than the basis.[44]

Gift Tax Consequences

When the value of the assets received by the obligor exceeds the value of the annuity, there is a possibility that a gift has occurred. This possibility is heightened by the court's position in *John C. W. Dix,*[45] which places a lower valuation on private annuities. Similarly, the obligor may have made a gift to the annuitant if the value of the annuity is greater than the value of the assets transferred to the obligor. The principal test for determining whether a gift has been made is the presence or absence of arm's-length bargaining.[46] If the purchase price was a result of arm's-length bargaining, then the unequal values in the exchange would not indicate an intent to make a gift. As one writer states: ". . . (N)o gift results from a bad bargain."[47] In the case of a family annuity, it is most difficult to prove that there was an arm's length transaction; therefore, in that situation property of equal value must be exchanged in order to avoid the gift tax. Of course, if the annuitant is attempting to avoid the estate tax by transferring the assets out of his gross estate it may still be to his advantage to pay a gift tax, because the gift tax rate is 25% less than the estate tax rate.

The exchange of equally valuable property creates a presumption that there is no gift; however, this presumption may be

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43 Rev. Rul. 55-119 *supra* n. 14.

44 *Ibid.*

45 See n. 18 *supra.*

46 See A. J. Casner, *Estate Planning* 265 (3d ed. 1961).

47 Middleditch, *supra* n. 6, at 161.

rebutted. The value of the annuity is based on standard actuarial tables which set out the life expectancy for each age.[48] If it is apparent that the annuitant's health is so precarious that he probably will not live out the period which life expectancy tables predict, then there may be a gift.[49] Therefore, "Expectancy tables are evidentiary only, and must yield to the realities of a particular case." [50]

The courts have approved several methods of determining the value of the annuity. One method has been to have an actuary examine the transaction and set a value.[51] This would seem to be a rather expensive technique, at least where the value of the transaction is not very great.

Another method is to equate the value of the private annuity with the cost of a comparable commercial annuity.[52] However, the *John C. W. Dix* case has abandoned this approach on the ground that the cost of commercial annuities are based on certain inherent factors causing them to be more expensive than private annuities.

The final approach, and the one taken by the *Dix* case, is to use the actuarial tables set out in the Treasury Regulations.[53] This will result in a lower value for the annuity and hence a lower basis. Therefore, the amount of the gift will be greater through the use of these tables. Furthermore, the transferor's basis will be reduced by the amount of the gift.[54]

Where the annuity takes the form of joint ownership, there will be a gift to the other annuitant if the latter did not provide any consideration for the annuity benefits. A problem may arise where the other annuitant is one's spouse in that the gift tax marital deduction will not apply to a life estate or to a terminable interest.[55] The language of the statute indicates that no deduction will be allowed in a gift to the spouse ". . . if the donor re-

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48 These life expectancies are presumably predicted for persons who are in good health.

49 See *Huntington National Bank of Columbus, Ohio,* 13 T.C. 760 (1949).

50 Ekman, *supra* note 21, at 145.

51 See *John C. Moore Corp.,* 15 B.T.A. 1140 (1929), *aff'd* 42 F.2d 186 (2d Cir. 1930); *Gladys Cheesman Evans,* 30 T.C. 798 (1958).

52 See *Raymond v. C.I.R.,* 40 B.T.A. 244 (1939), *aff'd* 114 F.2d 140 (7th Cir. 1940); *Gillespie v. C.I.R., supra* n. 4.

53 See n. 15.

54 Rev. Rul. 55-388 (1955-1 CUM. BULL. 233).

55 I.R.C. § 2523(b).

tains (an interest in the property) in himself. . . ."[56] However, where the specific form of ownership is a "joint interest," the interest of the donor shall not (for the purpose of § 2523(b)) be considered to be retained in himself. Therefore, an annuity which is jointly held will qualify for the gift tax marital deduction; a life estate given to the spouse will disqualify the gift for the marital deduction.

An interesting problem may arise where the annuity contract provides that the amount of the periodic payments may vary in accordance with investment experience (*e.g.* profit-sharing plans), cost of living indices, foreign currency exchange rates, or similar fluctuating criteria. At the time the annuity agreement is signed, it is impossible to determine the amount of the gift because the amount of the receipts depends on factors which are uncertain. No problem arises in collection of the income tax as no gain is realized until payment is made.[57] However, the gift tax is due in the year in which the gift is made, which is really the year that the *right* to the annuity payments (regardless of the year of receipt) vests. The taxpayer in this instance might be able to defer payment of the tax until such time as a gift is actually made on the ground that there is no practical way to compute a gift tax on the present transfer.

Estate Tax Consequences

Where the annuitant has transferred assets from his estate in return for an annuity contract for a life term there is normally no estate tax, because the assets producing the annuity are not owned by the annuitant at the time of his death.[58] This generalization must be qualified to the extent that a "survivorship" annuity, payable to a beneficiary surviving the decedent, is includible in the gross estate.[59]

On the other hand, there are various statutory tools by which the Commissioner may assert that even though the assets

[56] *Id.* at § 2523(b)(1).

[57] See Treas. Reg. § 1.72-2(b)(3)(i) (1956).

[58] As one commentator notes: "A person who purchases an annuity which provides only for payments to himself for his life has merely purchased a right to payments which will terminate at his death. His death ends his interest in the property and there is no property which passes at his death and nothing to which an estate tax can apply." 2 Beveridge, LAW OF FEDERAL ESTATE TAXATION § 12.04 (1956).

[59] I.R.C. § 2039.

have been transferred out of the estate, they nonetheless are includible for purposes of calculating the estate tax.

First, the assets may be considered part of the estate if there was a gift in contemplation of death.[60] If the transfer is for an asset of equal value, the problem does not arise. Of course the statute merely creates a presumption that a transfer made within three years prior to death was in fact a transfer in contemplation of death. Thus, the annuitant can at the time of the transfer create evidence that the said transfer was not in contemplation of death. For example, the fact that the annuitant made the transfer without legal advice demonstrated that he was not concerned with disposing of this property;[61] and evidence that the assets were transferred in order to maintain family control of a closely-held corporation demonstrated that it was not a transfer in contemplation of death.[62]

Another way to at least partially defeat the estate tax is to split up the transfer, ". . . so that the annuity transaction reflects an exchange of equal values, and the excess value is clearly treated as a separate gift." [63]

Second, the assets transferred may be deemed part of the estate if there was a transfer with a retained life estate.[64] The annuitant must avoid retaining any control of the assets which he has transferred. In *Greene v. United States*[65] the decedent, pursuant to an agreement, transferred securities and cash having a value in excess of $96,000 to her two daughters, upon their promise "to pay and deliver over said interest, dividends, and any and all income . . . during the period of her life." The court held this to be a transfer with a retained life interest; even though the daughters had legal title to the assets and income, they did not have the *beneficial* possession or enjoyment until after the annuitant's death. The court observed:

> This arrangement is comparable to transferring the securities to a third party who would pay the income as earned to the decedent for life and thereafter pay the principal to the daughters.[66]

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60 *Id.* at § 2035. See *Cornelia B. Schwartz Estate,* 9 T.C. 229 (1947); *Worcester County Trust,* 35 F. Supp. 970 (D.C. Mass. 1940).

61 *Des Portes v. United States,* 171 F. Supp. 598 (E.D. S.C. 1959).

62 *Estate of Hilda M. Lenna,* CCH T.C. Mem. 1960-153.

63 Ekman, *supra* n. 18, at 146.

64 I.R.C. § 2036. See *Cornelia B. Schwartz Estate, supra* n. 60.

65 237 F.2d 848 (7th Cir. 1956).

66 *Id.* at 853.

On the other hand, in *Hill's Estate v. Maloney*,[67] where shares of stock were given in return for a down payment and an annuity, the court held that there was no reserved life interest because "complete and immediate possession and enjoyment . . . were irrevocably vested. . . ."[68] Therefore, it would seem that in order to avoid § 2036, the annuitant must make an outright transfer, and in no event can the transaction be a secured one.[69]

Third, the assets may be drawn back into the estate if the transfer is one taking effect at death.[70] Of course the requirements of the statute must be met in order for the Commissioner to use this provision. That is, there must be a requirement in the agreement that the transferee survive the decedent, and the decedent must have retained a reversionary interest in the property of at least 5%.[71] The Commissioner attempted to rely on this provision in *Hirsh v. United States*,[72] but the court held that the assets were not includible because the transfer was absolute and there were no restrictions on sale or other disposition. Furthermore, the court noted that under the terms of the annuity agreement:

> . . . the securities were not chargeable with the annuity. Each of the four children was personally obligated to pay a specified amount regardless of whether any return was received from the securities and each child was financially able to pay the annuity.[73]

If the annuitant obtains a personal guarantee from the obligor, this might subject the assets to inclusion under § 2036, as discussed above. The easiest way to avoid inclusion under § 2037 is to tailor the transaction so that it does *not* meet the two statutory requirements.

Finally, it should be noted that in the event of the premature death of the obligor his estate will be liable for the remainder of the annuity payments called for by the contract. However, the present discounted value of these payments will be allowed as a deduction on his estate tax return (I.R.C. § 2053 (a) (3)),

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67 *Supra* n. 24.

68 *Id.* at 170-71.

69 See *Tips v. Bass*, 21 F.2d 460 (D.C. W.D. Texas 1927) (a transfer of property to children in return for the promise of a life-time annuity secured by personal notes of the children).

70 *Id.* at § 2037.

71 *Id.* at § 2037 (a) (1) - (2).

72 35 F.2d 982 (1929).

73 *Id.* at 985-86.

but only to the extent that such claim is not a gift (*Id.* at § 2053 (c) (1) (A)).

Practicality

Where assets other than a business are transferred to create the annuity, what factors should the annuitant consider? The most obvious tax advantage occurs when appreciated property is transferred—the income tax (only a portion of which is taxable) is deferred, and more than likely the assets will not be included in the gross estate. In addition, this arrangement allows a family to retain control over the assets.

On the other hand, there are a formidable number of potential disadvantages which the annuitant must keep in mind. Since the arrangement must take the form of an unsecured transaction in order to derive the full tax benefit, the annuitant should hesitate to choose an obligor in whom he does not place his complete trust. Of course if the annuitant is independently wealthy and does not have to depend upon the annuity for support, the above factor becomes less significant. Because there is no security, the annuitant must take the risk that the obligor may simply not honor the contract or may sell the assets; and if he has no other assets, there will be nothing on which to levy.

Another disadvantage is that the annuitant must completely relinquish control of the assets. This means that the arrangement must be irrevocable, and some persons may object to such a requirement because:

> Family circumstances may change in innumerable ways, but the transferor will have lost the flexibility of a testamentary disposition which would permit him to modify his estate plan in accordance with changed conditions.[74]

Moreover, if appreciated property is transferred and its value exceeds the value of the annuity, a gift tax will be incurred. The annuitant must be able to pay this tax liability. If he is not independently wealthy, he may have to borrow the funds.

Furthermore, this type of estate planning tool usually has the investment characteristic of providing only a fixed return. Thus it will not act as a hedge against inflation. However, as noted previously, it is possible to tailor the annuity to some fluc-

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[74] Wallace, *Taxation of Private Annuities,* 40 B.U.L. Rev. 374 (1960).

tuating criteria; hence the fixed-return limitation can be circumvented if there is a need for more growth potential in the estate assets of the annuitant.

Finally, the income from the assets transferred to the obligor will be added to his taxable income. The annuitant will want to determine the financial ability of the obligor to pay the tax on this income, as well as his ability to meet the cash flow requirements of the annuity contract.[75]

Where a business is transferred in return for the promise of an annuity, the principal advantage (in addition to the tax advantages described in connection with a non-business transfer of assets) is that the business remains in the family. If the annuitant offered the business for sale in order to purchase a commercial annuity, the other family members would be forced to raise money to buy the business themselves if they wished to retain it. The private annuity enables them to get the business with no cash outlay. Other advantages in using the private annuity to dispose of a business are: there are no advertising expenses, or broker's commissions; the sale is made to "natural successors," and easier payment terms are usually obtainable.[76]

To be balanced against these desirable features are the disadvantages stated previously (except that there will usually be confidence among family members), plus the following: the insecurity ascribable to the financial risks of the business and the perhaps limited business judgment of the obligor, who is to be managing the business (for it is essentially the business that will be paying off the annuity).

From the obligor's standpoint, such an arrangement is desirable because he usually obtains the assets without a down payment, and free from restrictions. However, he must assume the risk of the premature death of the annuitant, which would result in a lower basis for the assets. In addition, he cannot deduct the payments made; but in the case of depreciable property, he can recover his cost.

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[75] Mancina, *The Private Annuity*, 43 Taxes 257 (1965).

[76] *Id.* at 256.

Conclusion

While the Internal Revenue Code permits a partial postponement of the income tax in a private annuity transaction, the courts have not been sympathetic to taxpayers who attempted to take advantage of this device. While intra-family transfers are most common, the private annuity frequently has been used by corporations. In either case, the annuitant must realize that his security for the assets of which he relinquishes irrevocable control lies solely in the honor of the obligor. The parties must determine the value of the assets exchanged for the annuity contract, the frequency and amount of each annuity payment, and the life expectancy of both the annuitant and the obligor.

Finally, the parties should give consideration to income tax consequences and to the implications of the gift and estate taxes. Of course the private annuity may be attractive to a particular person not only because of its possible tax advantages, but also because of the ease with which it can be tailored to enable the obligor to fulfill his obligations.