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USING LIFE EXPECTANCY TABLES FOR PRIVATE ANNUITIES

— by Neil E. Harl*

Private annuities are entered into for a variety of reasons.[1] Some annuitants seek a stream of income that will continue until death of the annuitant — or annuitant and spouse under a joint and survivor annuity; others are moved by a desire to transfer significant assets such as farmland to someone in the next generation as obligor.

Another reason driving interest in private annuities is the motivation to enter into annuity arrangements after the onset of serious illness that has likely diminished life expectancy. If the obligor or obligors are family members, the result can be indeed favorable in terms of overall family wealth if the outcome is transfer of the property funding the private annuity for one or, at most, a few payments.

A set of new income tax, gift tax and estate tax regulations effective with respect to decedents dying after December 13, 1995[2] has altered the guidelines for determining when use of the life expectancy tables is appropriate.

"Death is imminent" rule

For many years, the question of when use of the life expectancy tables was appropriate has been made under a "death is imminent" rule.[3] Under that approach, the IRS position emphasized a facts and circumstances test —

> "...The current actuarial tables in the regulations shall be applied if valuation of an individual's life interest is required for purposes of the federal estate or gift taxes unless the individual is known to have been afflicted, at the time of transfer, with an incurable physical condition that is in such an advanced stage that death is clearly imminent. Death is not clearly imminent if there is a reasonable possibility of survival for more than a very brief period. For example, death is not clearly imminent if the individual may survive for a year or more and if such a possibility is not so remote as to be negligible. If the evidence indicates that the decedent will survive for less than a year, no inference should be drawn that death will be regarded as clearly imminent, because this question depends on all the facts and circumstances."[4]

An earlier ruling, *Rev. Rul. 66-307,*[5] involved the valuation of property interests for purposes of the credit for tax on prior transfers.[6] In the facts of that ruling, the life tenant-transferee was "afflicted with a ravaging and incurable disease of advanced state and could not survive a year." Indeed, the life tenant survived the transfer by less than four months. The life estate in the estate of the transferor had an actuarial value of about 52 percent but the life tenant received in benefits before death only about one percent of the value of the property.[7] That ruling concluded that if it is known on the valuation date that a life tenant is afflicted with a fatal and incurable disease in its advanced stages and the individual cannot survive for more than a brief period of time, the value of the life or remainder interest should be determined "by reference to such known facts."[8]

The "new" approach

A 1993 Tax Court case, *Estate of McClendon v. Commissioner,*[9] involved a taxpayer with an actuarial life expectancy of 15-years but who was suffering from a severe form of throat cancer. The court agreed that a substantially diminished life expectancy justified departure from the annuity tables.[10] A "savings" clause in a private annuity entered into by the taxpayer provided for an adjustment if challenged.[11] That clause was disregarded as against public policy.[12]

In late 1995, I.R.S. indicated that amendments to the income tax,[13] gift tax[14] and estate tax[15] regulations had superseded the two governing revenue rulings, *Rev. Rul. 80-80,*[16] and *Rev. Rul. 66-307,*[17] effective for estates of decedents dieing after December 13, 1995.[18]

Under the amendments to the regulations, the life expectancy tables and standard interest rate rules may not be used if an individual (who is a measuring life) dies or is terminally ill at the time the transfer is completed.[19] An individual who is known to have an incurable illness "or other deteriorating physical condition" is considered terminally ill if there is at least a 50 percent probability that the individual will die within one year.[20] However, if the individual survives for 18 months or longer after the date the transfer is completed, the individual is presumed to have not been terminally ill at the date the transfer was completed.[21] That presumption can be overcome only by clear and convincing evidence to the contrary.[22]

The regulations provide an example of how the regulatory language is to be applied —

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"The donor transfers property worth $1,000,000 to a child in exchange for the child's promise to pay the donor $103,000 per year for the donor's life. The donor is age 60 but has been diagnosed with an incurable illness and has at least a 50 percent probability of dying within 1 year. The section 7520 interest rate for the month of the transfer is 10.6 percent, and the standard annuity factor at that interest rate for a person age 60 in normal health is 7.4230. Thus, if the donor were not terminally ill, the present value of the annuity would be $764,569 ($103,000 x 7.4230). Assuming the presumption provided (in Treas. Reg. § 25.7520-3(b)(2)) does not apply, because there is at least a 50 percent probability that the donor will die within 1 year, the standard section 7520 annuity factor may not be used to determine the present value of the donor's annuity interest. Instead, a special section 7520 annuity factor must be computed that takes into account the projection of the donor's actual life expectancy."[23]

In conclusion

The key provision in the new regulatory language is the 50 percent probability of death within on year.[24] That is a substantially different rule from the "death is imminent" standard applicable previously.[25]

FOOTNOTES

1 See generally 6 Harl, *Agricultural Law* ch. 49 (1995); Harl, *Agricultural Law Manual* § 6.04 (1995).

2 Rev. Rul. 96-3, I.R.B. 1996-2.

3 Rev. Rul. 80-80, 1980-1 C.B. 194. See, e.g., Continental Illinois Nat'l Bank and Trust Co. v. United States, 504 F.2d 586 (1974).

4 Rev. Rul. 80-80, 1980-1 C.B. 194, 195.

5 1966-2 C.B. 429.

6 I.R.C. § 2013.

7 Rev. Rul. 66-307, 1966-2 C.B. 429.

8 *Id.*

9 T.C. Memo. 1993-459, *rev'd and rem.*, 96-1 U.S. Tax Cas. (CCH) ¶ 60,220 (5th Cir. 1996) (see summary below).

10 *Id.*

11 *Id.*

12 *Id.*

13 Treas. Reg. § 1.7520-3(b)(3).

14 Treas. Reg. § 25.7520-3(b)(3).

15 Treas. Reg. § 20.7520-3(b)(3).

16 1980-1 C.B. 194.

17 1966-2 C.B. 429.

18 Rev. Rul. 96-3, I.R.B. 1996-2.

19 E.g., Treas. Reg. § 25.7520-3(b)(3).

20 *Id.*

21 *Id.*

22 *Id.*

23 Treas. Reg. § 25.7520-3(b)(4).

24 Treas. Reg. § 25.7520-3(b)(3)

25 Rev. Rul. 80-80, 1980-1 C.B. 194.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

AUTOMATIC STAY. The debtors had signed-up for the 1988 farm programs for their rice and wheat crops. The debtors had received an advance disaster payment for the rice crop. Although the debtors eventually applied for full disaster payments, the USDA denied all disaster payments based on the failure of the debtors to follow normal cultural practices in growing the rice. After the debtors filed for Chapter 12, the USDA set off the advance disaster payment for the rice crop against disaster payments owed to the debtors for the wheat crop losses. The USDA did not petition for relief from the automatic stay before the setoff. The court ruled that the setoff violated the automatic stay and the debtors sought an award of attorney's fees for challenging the setoff. The court awarded about one-third of the claimed fees at a rate of $90.00 per hour. The court noted that the USDA was primarily responsible for the protracted nature of the proceedings. ***In re* Winchester, 191 B.R. 93 (Bankr. N.D. Miss. 1995)**.

AVOIDABLE TRANSFERS. The debtor was a producer of soybean seed and had contracted with a dealer to produce soybean seed from foundation seed owned by the dealer. The debtor also contracted with several growers to grow the seed. The debtor was to receive a premium on each bushel of seed delivered to the dealer and paid a premium to the growers out of the premium received from the dealer. The debtor lost its state grain license and its business was operated under the state Department of Agriculture for the purpose of winding up the debtor's affairs. Although most of the contract had been performed by the time the debtor filed for bankruptcy, several payments were made within 90 days prior to the filing. The payments were made to the state Department of Agriculture and were not part of the debtor's bankruptcy estate. The trustee sought to recover those payments as either fraudulent or preferential. The trustee alleged that the seed contract with the dealer was void because it was not written as required by Ill. Cod. Stat. ch. 505, § 105/1. The court held that the statute did not provide that an unwritten contract was void but only provided penalties for failing to put a seed contract in writing. The trustee also argued that the payments were preferential. The court held that the payments were made in the ordinary course of business as part of the contract. ***In re* Ostrom-Martin, Inc., 191 B.R. 126 (Bankr. C.D. Ill. 1996)**.

ESTATE PROPERTY. The debtor owned a tax deferred annuity contract which was tax qualified under I.R.C. § 403(b). The annuity contained a spendthrift clause which was effective under state law. The court held that the annuity contract was not estate property under Section 541(c)(2). ***In re* Johnson, 191 B.R. 75 (Bankr. M.D. Pa. 1996)**.