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New Proposed Regulations on Private Annuities

-by Neil E. Harl*

On October 18, 2006, the Department of the Treasury issued new proposed regulations on private annuities¹ which will affect most private annuities entered into after April 17, 2007 and some entered into after October 18, 2006.² The proposed regulations will render the private annuity less attractive as an estate and business planning tool.³ Basically, the new rules specify that, in a private annuity setting, the transferor and transferee of property are left as if the transferor had sold the property for cash and used the proceeds to purchase an annuity contract.⁴ The established rule of deferring the gain on the property funding the private annuity over the transferor's life expectancy⁵ would not be available.⁶

Previous treatment of private annuities

A private annuity involves a transfer of property (such as land) from the transferor (the annuitant) to a transferee (the obligor) who has not from time to time written annuities, in consideration of the obligor's unsecured promise to make periodic payments of money to the annuitant for a specified time or for the life of the annuitant.⁷ If the present value of the obligation to make the required payments is less than the fair market value of the property at the time of the transfer, the transaction is deemed a gift to the extent of the difference.⁸ The present value of annuities is determined by applying an interest rate of 120 percent of the midterm applicable federal rate published for the month of valuation.⁹

With respect to income tax treatment of an unsecured private annuity, if the value of the property exceeds its adjusted basis, as it usually does with farm property, the annuitant does not recognize gain in the year of the transfer.¹⁰ This is because there is no ascertainable fair market value if there is uncertainty as to the ability of the obligor as an individual to pay when the time for payment arrives.¹¹ If the promise to pay is secured, there is more certainty as to value and taxable gain may be recognized to the annuitant measured by the difference between the annuitant's basis in the property transferred and the present value of the annuity contract.¹² The gain is reported ratably over the period of years measured by the annuitant's life expectancy.¹³ If the property transferred is a Section 1245 or Section 1250 asset, part of the gain otherwise taxable to the annuitant as capital gain is taxed as ordinary income.¹⁴

The obligor may not claim an income tax deduction for interest or an allowance for interest.¹⁵ The imputed interest or unstated interest rules do not apply to private annuities;¹⁶

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moreover, the installment sale rules do not apply to a private annuity.¹⁷

The cost of the property is uncertain to the obligor; therefore, the basis for the property for purposes of depreciation and for sale or exchange is likewise uncertain and is subject to adjustment for the total payments made.¹⁸ Annuity payments are not tax deductible.¹⁹ The basis for cost recovery is the value of the prospective annuity payments to be made under the annuity; excess payments are added to the basis when and if made. After death of the annuitant, subsequent cost recovery is computed using the total payments actually made as the basis. In the event of sale of the property *before* the annuitant's death, the basis for computing gain is the total of payments actually made plus the present value of future payments remaining to be paid based on the annuitant's life expectancy as of the date of disposition of the property. For purposes of computing *loss* on the sale of the property before the annuitant's death, the basis is the total of all payments actually made to the date of sale.

The proposed rules

Under the proposed rules, for exchanges of property for an annuity contract after October 18, 2006,²⁰ the amount realized is the fair market value of the annuity contract at the time of the exchange determined under I.R.C. § 7520.²¹ The entire amount of the gain or loss, if any, is recognized at the time of the exchange.²² Thus, the transaction is treated essentially as a sale for cash with the proceeds used to acquire the annuity contract.

For a limited class of transactions, the effective date is delayed for six months (until April 17, 2007), for transactions in which—(1) the issuer of the contract is an individual; (2) the obligations are not secured, either directly or indirectly; and (3) the property transferred in the exchange is not subsequently sold or otherwise disposed of by the transferee (the obligor) during the two year period beginning on the date of the exchange.²³ That provision embraces most annuities of the type used in farm or ranch settings. Those contemplating a private annuity should consider carefully the opportunity to utilize the established rules during the additional six month period.

Footnotes

¹ See generally 6 Harl, *Agricultural Law* Ch. 49 (2006); Harl, *Agricultural Law Manual* § 6.04 (2006). See also Harl, "Private Annuity: Useful Concept or Troublemaker?" 1 *Agric. L. Dig.* 153 (1990).

² Prop. Treas. Reg. §§ 1.72-6(e), 1.1001-1(j).

³ *Id.*

⁴ *Id.*

⁵ See Rev. Rul. 69-74, 1969-1 C.B. 43.

⁶ See note 2 *supra*.

⁷ See Harl, *Agricultural Law* § 49.01[1] (2006).

⁸ I.R.C. § 2512(b). See Estate of Bergan v. Comm'r, 1 T.C. 543 (1943), *acq.*, 1943 C.B. 2; Treas. Reg. § 25.2512-5; Rev.

Rul. 69-74, 1969-1 C.B. 43. See also Cullison v. Comm'r, T.C. Memo. 1998-216 (gift from exchange of farmland for private annuity).

⁹ I.R.C. § 7520(a).

¹⁰ See Lloyd v. Comm'r, 33 B.T.A. 903 (1936), *acq.*, 1950-2 C.B. 3.

¹¹ Rev. Rul. 69-74, 1969-1 C.B. 43. See Comm'r v. Kann's Estate, 174 F.2d 357, 359 (3d Cir. 1949); Stern v. Comm'r, T.C. Memo. 1992-374 (gain on transfers of stock to foreign trust in exchange for private annuities deferrable).

¹² Estate of Bell v. Comm'r, 60 T.C. 469 (1973) (stock transferred placed in escrow to secure the promise to the annuitant and agreement provided for cognovit judgment in event of default); 212 Corp. v. Comm'r, 70 T.C. 788 (1978) (secured by rents from property, agreement not to sell or mortgage property without consent of transferors and confession of judgment in event of default).

¹³ Rev. Rul. 69-74, 1969-1 C.B. 43.

¹⁴ I.R.C. §§ 1245, 1250.

¹⁵ Rye v. United States, 25 Cls. Ct. 592 (Cls. Ct. 1992).

¹⁶ I.R.C. § 483(f)(5). See Rye v. United States, 25 Cls. Ct. 592 (Cls. Ct. 1992).

¹⁷ *Id.*

¹⁸ Rev. Rul. 55-119, 1955-1 C.B. 352.

¹⁹ See Rev. Rul. 72-81, 1972-1 C.B. 98.

²⁰ Prop. Treas. Reg. § 1.1001-1(j)(2).

²¹ Prop. Treas. Reg. § 1.1001-1(j)(1).

²² See Treas. Reg. § 1.451-1(a), Prop. Treas. Reg. § 1.1001-1(j)(1).

²³ Prop. Treas. Reg. §§ 1.72-6(e)(2)(ii), 1.1001-1(j)(2)(ii).