PRIVATE ANNUITY: USEFUL CONCEPT OR TROUBLEMAKER?

— by Neil E. Harl

As an estate planning concept, the private annuity is seldom included in formal estate plans but more frequently employed by families acting without professional assistance who are seeking to assure income for so long as the parents live.1 The private annuity is best known for the problems inherent in its use; however, there are situations where the private annuity can be a useful part of an overall estate plan.

With a private annuity, property other than cash (often land) is exchanged by the annuitant for a promise by the obligor to make periodic cash payments to the annuitant or annuitant and spouse so long as they live.

Example: Father conveys 160 acres of farmland valued at $120,000 with a basis of $40,000 to his daughter in exchange for the daughter's promise to pay the father $14,400 per year for the rest of the father's life. The fact that the amount of each payment by the obligor is fixed in dollar terms distinguishes the private annuity from a support contract that is typically based on the annuitant's support needs for their remaining life.

Non-tax problems. A full consideration of the non-tax problems associated with a private annuity is often sufficient to rule out its use. These factors include the fact that —

• The obligor may be unable to make payments because of insolvency or bankruptcy. Private annuities usually do not involve retention of a security interest by the annuitant in the transferred property inasmuch as retention of such an interest results in the transfer being treated as a sale.2 Moreover, if an obligor defaults, the relief provisions of Section 1038 of the Internal Revenue Code applicable to repossessions of real property do not apply because the obligation is not secured by the land as is required for use of the regular repossession rules.3
• The annuitant may live a shorter than normal life, to the chagrin of the other heirs. Indeed, a private annuity may result in little more than a transformation of wealth from one form to another if the annuitant lives on social security benefits and other sources of income.

Income tax treatment. 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 the gain in the year of transfer.4 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.5 As noted above,6 if the private annuity is secured by the transferred property, the transaction is treated as a sale with recognition of gain in that year.

The gain realized on a private annuity transaction is determined by subtracting the transferor's income tax basis in the property from the present value of the annuity.7 The gain is reported ratably over the period of years measured by the annuitant's life expectancy.8 The investment in the contract (transferor's adjusted basis in the property transferred) is divided by the expected return under the contract (annual payment multiplied by the annuitant's life expectancy) to determine the exclusion ratio. The exclusion ratio multiplied by the annual payment gives the amount of non-taxable return of basis.

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1 Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University; member of the Iowa Bar.

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4 Inflation (or deflation) may have a marked effect on the real value of the fixed income of the annuitant.

5 The obligation on the obligor to make payments may become an impossible burden in difficult economic times as in the mid 1980s.

6 The obligor may die prematurely, thus adding to the uncertainty of whether the annuity payments will be made as scheduled. It may be desirable for the obligor to maintain insurance on his or her own life to protect against a loss to the obligor's estate in the event the obligor should predecease the annuitant with the obligation to make payments continuing to be a burden to the obligor's heirs.

7 Unless consumed or given away, the amounts received under a private annuity may accumulate to increase the value of the gross estate if the annuitant lives a normal or longer than normal life. Indeed, a private annuity may result in little more than a transformation of wealth from one form to another if the annuitant lives on social security benefits and other sources of income.

8 The difference, annually, between the amount reportable as capital gain plus the amount received as non-taxable return of
basis and the annual annuity payment is reported as ordinary annuity income. For annuities before 1987, the exclusion ratio is applicable throughout the life of the annuity contract. For annuities after 1986, the exclusion applies only for the annuitant's life expectancy.9

Example: returning to the facts in the above example of $120,000 in farmland transferred in exchange for $14,400 per year in equal monthly payments, the calculations would be as follows assuming a 74-year old male taxpayer and assuming a 10 percent discount rate10

Total expected payments, 10.1 years x 14,400 $145,440
Present value of annuity 81,051
Amount of basis 40,00011
Amount of gift (120,000 – 81,051) 38,949
Amount of capital gain (81,051 – 40,000) 41,051
Annual capital gain (first 10.1 years) 41,051/10.1 4,064
Annual return of basis (fixed 10.1 years), 40,000/10.1 3,960
Ordinary annuity income (first 10.1 years) 14,400 – (3960 + 4064) 6,376
Ordinary annuity income (after 10.1 years) 14,400

The imputed or unstated interest rules do not apply to private annuities.12 And the obligor may not claim an income tax deduction for interest in a private annuity.13

For the obligor, the cost of the property is uncertain; therefore, the income tax basis for the property is likewise uncertain and is subject to adjustment for the total payments made.14 The basis for depreciation is the value of the prospective annuity payments to be made under the annuity. Excess payments are added to basis when, and if, made. After the death of the annuitant, subsequent depreciation is completed 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 at the date of disposition of the property. For purposes of computing loss on sale of the property before the annuitant's death, the basis is the total of all payments actually made to the date of sale. If the selling price is less than the adjusted basis for purposes of figuring gain and greater than the adjusted basis for loss, neither gain nor loss is recognized.

If the property is sold after the annuitant's death, the basis for computing gain or loss is the total of all payments actually made. Thus, premature death of the annuitant would leave a low basis for the property involved.

**Federal estate tax concerns.** As with a commercial annuity, the value of property transferred in a private annuity transaction (assuming no complicating gift is present) is not included in the annuitant's gross estate for federal estate tax purposes if the right to receive payments terminates upon the death of the annuitant. However, if the value of the property transferred exceeds substantially the value of the annuity agreement, the transaction may be held to be a transfer of property with a retained life estate.15 Similarly, if the annuitant retains control over the property during his or her lifetime, or the obligor's use of the property is contingent upon the death of the annuitant, the transaction may be treated as a transfer with a retained interest with the full value of the property included in the annuitant's estate.16

In order to reduce the possibility that a life estate is considered to have been retained, several points should be observed —

- If income-producing property is transferred, the annuity payments should not be set equal to the annual income earned from the property. Moreover, the obligor should not follow the practice of giving the annuitant a promissory note each year equal in amount to the difference between the required payment and the income from the property.

- The annuity agreement should impose personal liability on the obligor and specifically state that the obligor is liable for the annuity payments without regard to the income earned by the property.

- To the extent that the annuitant has a choice in the matter, the obligor should be an individual with substantial sources of income over and above the income from the property. In one ruling,17 the Internal Revenue Service took the position that the annuitant retained a life estate in the property transferred for an annuity, where the trust as obligor had no income with which to make the annuity payments aside from the income generated from the property itself. The same argument might be made if the obligor is an individual who has no significant income in excess of normal personal and business expenses except from the property transferred.

- The annuitant should relinquish complete ownership of the property. The annuitant should retain no veto power over the sale of the property, nor should the annuitant continue to receive any benefits from the property, directly or indirectly.18

- If the annuitant retains a security interest in the property transferred so that it may be repossessed, the arrangement could be considered a transfer intended to take effect at death19 as well as a sale (for income tax purposes).20

### FOOTNOTES

2 Est. of Bell v. Comm'r, 60 T.C. 469 (1973); 212 Corp. v. Comm'r, 70 T.C. 788 (1978).
3 Treas. Reg. § 1.1038-1(a)(1).
6 See note 2 *supra* and accompanying text.
7 See Rev. Rul. 69-74, 1969-1 C.B. 43 (procedure is correct but figures are based upon outdated 3-1/2 percent annuity tables).
10 Since May 1, 1989, the discount rate has been set at 120 percent of the midterm applicable federal rate for the month of valuation. I.R.C. § 7520(a).
11 Rev. Rul. 69-74, 1969-1 C.B. 43, 44, maintains the full amount of the basis from the property as the basis figure for private annuity calculations even where a substantial gift has been made in conjunction with the private annuity transaction as with this example. Arguably, a fractional portion of the basis from the property should carry over to the donee and the remaining basis should be used in the private annuity calculations.
12 I.R.C. § 483(f)(5).
CASES, REGULATIONS AND STATUTES

BANKRUPTCY

GENERAL

EXEMPTIONS. The debtors argued that the value of their homestead should be decreased for the amount of a real estate broker's commission and a trustee's commission for the purpose of determining whether a judicial lien impaired the homestead exemption. The court held that the commissions could not be deducted from the fair market value of the homestead where neither the debtors nor the trustee planned to sell the homestead. In re Yackel, 114 B.R. 349 (Bankr. N.D. N.Y. 1990).

The debtor owned an interest in an employee retirement plan which qualified under I.R.C. § 401 but which allowed the debtor to withdraw any amount, subject only to length of service requirements. Under N.Y. Civil Practice Rule 5205, employee retirement plans which qualified under I.R.C. § 401 were presumed to be spendthrift trusts. The court held that under the presumption of Rule 5205, the debtor's interest in the employee retirement plan was exempt. In re Kleist, 114 B.R. 366 (Bankr. N.D. N.Y. 1990).

The debtors' interest in an ERISA qualified pension benefit plan was exempt under ERISA as a non-bankruptcy federal exemption. The Tennessee exemption was held preempted by ERISA. In re Messing, 114 B.R. 541 (Bankr. E.D. Tenn. 1990).

A husband and wife filed a joint petition for bankruptcy and each claimed the $8,000 Missouri homestead exemption for a total $16,000 exemption for their home. The court held that the debtors were limited to one state exemption for their homestead although Section 522 allows exemptions for each separate debtor in a joint filing. In re Riebow, 114 B.R. 656 (Bankr. E.D. Mo. 1990).

A creditor held a judicial lien against the debtors' homestead and the debtors attempted to avoid the lien as impairing their exemption in their equity in the homestead. The creditor argued that the lien did not impair the homestead exemption because under Colorado law, a judicial lien cannot attach to a homestead but can only attach to the proceeds of the sale of a homestead. The court held that the judicial lien may be avoided because it otherwise impairs the debtors' fresh start afforded by the homestead exemption. In re Robinson, 114 B.R. 716 (D. Colo. 1990).

FEDERAL TAXATION

DISCHARGEABLE DEBTS. The debtors argued that their federal income taxes were dischargeable because the tax return was filed within two years of filing bankruptcy. The court held that the debtors were not allowed a discharge because the federal income taxes stated in the return were due within three years of the filing of the bankruptcy petition. Smith v. U.S., 114 B.R. 473 (W.D. Ky. 1989), aff’d 109 B.R. 243 (Bankr. W.D. Ky. 1989).

CONTRACTS

JURISDICTION. The plaintiff, a resident of North Carolina, purchased a horse in South Carolina. The court held that in personam jurisdiction could be asserted over the defendant based on the following contacts with North Carolina--(1) the plaintiff learned about the horse from an ad placed in a magazine of national circulation and sold in North Carolina, (2) a condition of the sale (an the central issue to the dispute) was that a North Carolina veterinarian would examine the horse for suitability for the plaintiff's intended use, and (3) the veterinarian did examine the horse in North Carolina. Because the veterinarian rejected the horse for the plaintiff's intended use, the trial court held that the defendant was required under the sales agreement to refund the purchase price and take back the horse. Watson v. Graf Bae Farm, Inc., 392 S.E.2d 651 (N.C. App. 1990).

FEDERAL AGRICULTURAL PROGRAMS

COMMODITY FUTURES TRADING. The CFTC has issued a proposed rule broadening the eligibility for the exemption from speculative position limits to commodity trading advisors, simplifying the application process for the exemption and other technical amendments. 55 Fed. Reg. 30926 (July 30, 1990).

CCC LOANS. The plaintiff entered into a loan with the CCC which was secured by corn under seal. The plaintiff sold the corn, under authorization from CCC, to a third party which paid for the corn with a check made out to CCC. The CCC, however, did not present the check for collection for 19 days and when the check was presented, it was returned because the account was closed and the buyer insolvent. The plaintiff's alleged that the CCC had a duty to present the check for payment within a shorter period of time. The court held that under the loan security agreement and the sale...