



ILLINOIS STATE BAR ASSOCIATION

# TRUSTS & ESTATES

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## Private annuities

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A private annuity can be an effective way of transferring wealth to a family member, freezing the estate, avoiding estate and gift tax, and ensuring a lifetime stream of income. If the estate planning goal is to transfer assets to family members during lifetime without any gift tax consequences, yet retain some, a private annuity may be an effective tool in this low interest rate environment. Low interest rates reduce the income stream returning to the transferor while optimizing the amount transferred to the beneficiary.

A private annuity (with "private" meaning that neither party can be in the business of selling annuities) is an agreement between two parties, who are generally referred to as the "annuitant" and the "obligor." In estate planning, usually these parties are family members. The strategy entails the annuitant (i.e. the parent) transferring property to the obligor (i.e., the child) in return for the obligor's guarantee to make fixed payments back to the annuitant over the remainder of the annuitant's life. Because the annuity payments are guaranteed, this transaction is treated as a sale and not as a gift. Ideally, the transferred property is appreciated property.

The annuity payments are based on the fair market value of the assets at the time of the transfer and the IRC Section 7520 interest rate (which is hovering around historical lows in the 2.0 percent range). Once the annuity payments are determined, they cannot subsequently be changed. The IRS carefully scrutinizes private annuities to make sure that the sale isn't really just a sham (a gift in disguise), so the use of a professional appraiser (for the appreciated property, if necessary) is highly recommended.

Each annuity payment received by the

annuitant is considered a partial return of capital (no income tax implications), with the rest being treated as interest, and potentially some capital gain. When an appreciated asset is exchanged for a private annuity, the capital gain can be deferred until the annuitant begins receiving annuitant payments. The capital gain portion of the annuity payment is then recognized evenly over the annuitant's life expectancy. This provides the planning opportunity to transfer assets with a low basis but with a high possibility of appreciation. The annuitant taxed will be taxed at the capital gain rate over a period of years rather than all in one year. Unfortunately, IRC proposed Regulation 141901-05 threatens to eliminate this benefit and cause recognition of the capital gain in the year of the transfer.

The flipside is that after receiving the property, the obligor's basis in the transferred property is its fair market value. But as the annuity continues making payments, the obligor's basis increases once the total payments surpass the obligor's original basis. If the annuity lasts long enough, the obligor's basis in the transferred assets will actually increase. This gives the obligor the option to wait to sell the assets until the basis of the assets catches up to the current fair market value of the assets, thereby avoiding capital gain tax.

Tax considerations aside, the key to this technique is that it is a strategy that focuses on early death. If the annuitant dies prior to receiving total payments equaling the value of the transferred assets the obligor receives a tax free gift equal to the difference between what was paid and what was received. Nonetheless, even if the annuitant lives long enough to receive back the entire value of

the transferred assets, the annuitant still benefits by having ensured that the specific transferred assets were given to the desired individual and that all future appreciation is out of the estate, often referred to as a "freeze technique."

In summary, here are the potential benefits and disadvantages of this strategy:

### Benefits

- 1. Estate & Gift Tax-** a private annuity avoids the estate and gift tax on the transferred assets that would otherwise be due if the annuitant were to have died with the assets still in the annuitant's control or if the assets were to have been gifted to a family member.
- 2. Income Tax-** any future increase in value in the transferred assets will be taxed to the obligor, not the annuitant. If the obligor is in a lower income tax bracket than the annuitant, this can be highly beneficial. Also, if the property is appreciating at a rate faster than the Section 7520 rate, the obligor will be increasing his or her net worth.
- 3. Deferral of Gain-** if the property transferred by the annuitant to the obligor has a basis lower than the fair market value of the property, the gains on the property do not need to be recognized upon transfer. Instead, the gains are distributed ratably to the annuitant over the course of the annuity.
- 4. Retirement Benefits-** because the annuitant receives a lifetime stream of income, this can be a reliable source of funds for a retiree.
- 5. Intra-Family Wealth Management-** a private annuity between family members ensures that the transferred assets remain

within the family.

### **Disadvantages**

- 1. The Unknown-** if the annuitant lives longer than expected or if the value of the transferred assets decrease, then the obligor could end up losing money due to the fixed annuity payments.
- 2. Default Risk-** if the obligor dies before the annuitant or experiences financial

difficulties and the annuitant is reliant on the annuity payments, then the income stream the annuitant was relying upon may cease, thereby creating hardship for the annuitant. This can be mitigated if the annuitant purchases a life insurance policy on the obligor.

- 3. No Step-Up in Basis-** if the annuitant dies and the obligor still possesses the transferred assets, the obligor's basis in the

assets is the total of the payments made, which can be less than if the obligor would have simply inherited the assets from the annuitant.

- 4. No Interest Deduction-** the obligor is unable to deduct the interest payments made to the annuitant on the annuity payments. ■

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