



Take That, Private Annuities—IRS Issues Proposed Regulations
Podcast of October 21, 2006



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IRS Changes the Treatment of Private Annuities

This week the IRS announced proposed regulations that would radically change the treatment of private annuities, a technique that was used in a number of contexts, but which the IRS now feels was being abused in a number of cases. If these proposed regulations go into affect as they currently stand, they would impact private annuity arrangements beginning on October 18, 2006—meaning, they would impact any being created today. In the case of some arrangements that the IRS has decided are “less abusive” there will be a temporary reprieve that will allow such transactions to be taxed under the old rules for six months after the effective date of these regulations—or, essentially, through the next 1040 filing deadline.

While the use of private annuities as a tax planning device probably wasn't an everyday event for most practitioners, many of us have run into the concept over the years and may find it has been proposed to clients in various contexts—so it's important to know that there is more than a slight chance the rules may have changed dramatically for the treatment of such annuities.

Private Annuities

A private annuity is an annuity issued to an individual by someone other than a commercial insurance carrier. The key issue here is when the annuity is issued in exchange for an appreciated asset held by the individual. Under Revenue Ruling 69-74 the IRS outlined the treatment of such transactions, a treatment that will no longer be acceptable under the proposed regulations.

In the ruling, the IRS outlined the following transaction that was used to illustrate the treatment of private annuities:

In the instant case, the taxpayer, age 74, transferred property (a capital asset) having an adjusted basis of \$20,000, and a fair market value of \$60,000, to his son in 1966, in exchange for the legally enforceable promise of the latter to pay him a life annuity of \$7,200 per annum payable in equal monthly installments of \$600.

The ruling outlined the tax treatment by stating four principles to be used in determining the estate and income taxation of the transaction:

Accordingly, the tax consequences of the private annuity transaction in this case are determined by applying the following principles:

- (1) The gain realized on the transaction is determined by comparing the transferor's basis in the property with the present value of the annuity. Section 1.101-2(e)(1)(iii)(b)(3) of the regulations prescribes the appropriate table to be used for valuing a private annuity contract. (U.S. Life Table 38 contained in paragraph (f) of section 20.2031-7 of the Estate Tax Regulations.) The gain realized will be capital gain if the transferred property constitutes a capital asset.
- (2) The excess of the fair market value of the property transferred over the present value of the annuity acquired constitutes a gift for Federal gift tax purposes where the transaction is not an ordinary business transaction within the meaning of sections 25.2511-1(g)(1) and 25.2512-8 of the Gift Tax Regulations.
- (3) The gain should be reported ratably over the period of years measured by the annuitant's life expectancy and only from that portion of the annual proceeds which is includible in gross income by virtue of the application of section 72 of the 1954 Code. This will enable the annuitant to realize his gain on the same basis that he realizes the return of his capital investment.
- (4) The investment in the contract for purposes of section 72 of the 1954 Code is the transferor's basis in the property transferred. Since the amount of the gain is

not taxed in full at the time of the transaction, such amount does not represent a part of the "premiums or other consideration paid" for the annuity contract.

For income tax purposes, each payment divides into three pieces:

- Nontaxable return of capital (the portion of the annuity that represents original basis)
- Capital gain
- Ordinary income from the annuity

The computation works as follows:

(1) Based on U.S. Life Table 38, with interest at 3 1/2 percent, the present value of the right of a person age 74 to receive a life annuity of \$7,200 per annum is \$47,713.08.

(2) The excess of the fair market value of the property transferred over the value of the annuity received as a gift to the son from the father. (\$60,000 minus \$47,713.08 is \$12,286.92, the gift made by the father to his son.)

(3) The basis of the property is \$20,000.

(4) The excess of the value of the annuity received over the basis in the property transferred represents the gain realized. (\$47,713.08 minus \$20,000 is \$27,713.08 the gain realized.) See section 1.1001-1(e)(1) of the Income Tax Regulations.

(5) The computation and application of the exclusion ratio, the gain, and the ordinary annuity income is as follows:

\$72,720 expected return (annual proceeds multiplied by 10.1, the life expectancy).

\$20,000 (investment in the contract) divided by \$72,720 (expected return) results in an exclusion ratio of 27.5 percent.

(a) Annual proceeds, \$7,200.

(b) Exclusion (27.5 percent of \$7,200), \$1,980.

(c) Capital gain income (\$27,713.08) divided by 10.1 years (the life expectancy), \$2,743.87.

(d) Ordinary annuity income: (a), minus the total of (b) plus (c), \$2,476.13.

The exclusion ratio of 27.5 percent is applicable throughout the life of the contract. After the capital gain of \$27,713.08 has been fully reported, subsequent amounts received (after applying the exclusion ratio) are to be reported as ordinary income.

Note that changes in IRC §72(b) removed the ability to continue using the exclusion ration after the investment in the contract was recovered, but otherwise the treatment is basically as written above.

As well, older case law suggested that an “open transaction” treatment might be appropriate because the ultimate payment could not be computed with certainty.

Proposed Change

The IRS indicated that it was making a change because of concern that the treatment was being abused. The IRS noted:

The Treasury Department and the IRS have learned that some taxpayers are inappropriately avoiding or deferring gain on the exchange of highly appreciated property for the issuance of annuity contracts. Many of these transactions involve private annuity contracts issued by family members or by business entities that are owned, directly or indirectly, by the annuitants themselves or by their family members. Many of these transactions involve a variety of mechanisms to secure the payment of amounts due under the annuity contracts.

The IRS also indicated that they believed that developments since the old case law and the Revenue Ruling in the treatment of streams of payment meant that it was no longer appropriate to treat private annuities under such special rules:

The Treasury Department and the IRS believe that neither the open transaction approach of *Lloyd v. Commissioner* nor the ratable recognition approach of Rev. Rul. 69-74 clearly reflects the income of the transferor of property in exchange for an annuity contract. Contrary to the premise underlying these authorities, an annuity contract - whether secured or unsecured - may be valued at the time it is received in exchange for property. See generally section 7520 (requiring the use of tables to value any annuity contract for federal income tax purposes, except for purposes of any provision specified in regulations); §1.1001-1(a) ("The fair market value of property is a question of fact, but only in rare and unusual circumstances will property be considered to have no fair market value."). The Treasury Department and the IRS believe that the transferors should be taxed in a consistent manner regardless of whether they exchange property for an annuity or sell that property and use the proceeds to purchase an annuity.

Under the proposed regulations, taxpayers would be treated in the same manner as if they had sold the property in question for cash equal to the value of the stream of payments computed under Section 7520, and then used that cash to purchase annuity.

That would have the following impacts if the property's value was equal to the discounted value of the stream of payments:

- There would be immediate recognition of a sale in the amount of the value of the annuity. The basis of the property would be offset against that value, and the gain immediately taxed.
- The investment in the annuity received would now be that discounted value of the stream of payments, meaning that each payment would consist of a return of capital and an ordinary income portion until the entire investment in the contract was recovered.

If the value of the property was greater than the value of the annuity, the transaction would be treated as a partial sale and partial gift.

What was the IRS After?

The structure that likely upset the IRS would go something like this under the old rules. An irrevocable trust would be set up which would purchase the asset from the owner and give back a life annuity that would compute to be worth the fair value of the asset. That trust's basis in the property would be that fair market value, since it had just given up an annuity equal to that value.

The trust would then sell the property to another party for its fair value. Since the trust's basis was equal to that value, no gain would be recognized at the trust level. The trust would invest the proceeds so that it would have a stream of cash. And the seller would only recognize gain slowly over time as the annuity was paid. The only income tax the trust would pay would be based on the investment gains on the principal itself—and, as you'll note, the entire value of the principal could be reinvested at the front end since no current tax was due.

On top of that, some arrangements worked to effectively secure those payments to assure the seller didn't face any real risk on the payout.

The IRS's rule changes do take out this transaction—but also take other ones that weren't meant to defer tax on a gain from selling the property for cash.

Temporary Reprieve

The IRS did recognize that there were nonabusive transactions out there that also took advantage of this ruling as it was designed to be used. The IRS does not exempt such transactions from these regulations, but rather simply delays the effective date for such transactions so taxpayers that had such nonabusive transactions in process will be allowed to complete them so long as they are completed within six months.

To qualify for this relief, a transaction must meet the following tests:

- (A) The issuer of the annuity contract is an individual;
- (B) The obligations under the annuity contract are not secured, either directly or indirectly; and

(C) The property transferred in exchange for the annuity contract is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange. For purposes of this provision, a disposition includes without limitation a transfer to a trust (whether a grantor trust, a revocable trust, or any other trust) or to any other entity even if solely owned by the transferor.

Remember that even these transactions will eventually be subject to immediate taxation down the line.

IRS Releases Qualified Plan 2007 Limitations

The IRS also released this week the updated limitations for plans. Those limitations are shown below:

	2006	2007
Annual Compensation Limit (§401(a)(17))	\$220,000	\$225,000
Dollar Limitation on Annual Benefits Under a Defined Benefit Plan (§415(b)(1)(A))	\$175,000	\$180,000
Dollar Limit on Annual Additions to a Defined Contribution Plan (§415(c)(1)(A))	\$44,000	\$45,000
Definition of Highly Compensated Employees (§414(q)(1)(B))	\$100,000	\$100,000
Definition of Key Employee Under Top Heavy Plan (§416(i)(1)(A)(i))	\$140,000	\$145,000
Limit on Elective Deferrals under 401(k) and 403(b) Plans	\$15,000	\$15,500
Dollar Limit on Deferrals under a 457(b) "Eligible" Deferred Compensation Plan (§457(e)(15))	\$15,000	\$15,500
Age 50+ Catch-Up Contributions (401(k) plans)	\$5,000	\$5,000

(Information Release 2006-162)