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Warren Salomon

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I. INTRODUCTION

An annuity is an agreement to make regular payments of a fixed sum for a period of one or more lives, or for a term of years. The most common form is the straight life annuity, which provides for fixed periodic payments for the life of a single person.

A commercial annuity is usually issued by an insurance company or other organization which regularly issues such contracts, and the consideration for the contract is usually cash.

A private annuity is a transaction in which a person who is not engaged in the business of writing annuity contracts receives property in exchange for his promise to make periodic payments to another person. Generally this takes the form of a straight life annuity.

There is also the so-called "semi-private" annuity, issued by an organization such as a corporation, trust, fund or foundation (other than a commercial insurance company) which from time to time issues annuity contracts.[1]

The person who transfers property in exchange for an annuity is called the "transferor" and also the "annuitant." The recipient of the property who promises to pay the annuity is called the "transferee" and also the "obligor." For convenience, since this paper will be concerned only with private annuities between family members, the transferor-annuitant will be referred to as the "father" and the transferee-obligor will be referred to as the "son."

II. TAX IN THE YEAR OF THE TRANSACTION

The transaction wherein property is exchanged for an annuity is regarded as having two aspects. It is both the sale of the property and

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1. Rev. Rul. 136, 1962-2 CUM. BULL. 12.

the purchase of an annuity.[2] It is an ideal device for disposing of property which has appreciated in value because any gain which the father realizes on the transaction will not be taxed immediately.[3] This is because what the father has received for his property, the unsecured promise of his son to make payments in the future, cannot be valued in terms of cash.[4]

Similarly, if depreciated property is used, no loss will be recognized. In most intra-family annuities, section 267 of the Internal Revenue Code bars the recognition of loss because of the relation between the parties. Even if the parties are unrelated, the open nature of the transaction, and the fact that it is not a transaction entered into for profit, have caused courts to deny the father a loss deduction.[5] Although these reasons have been criticized, the rule seems sufficiently well established that the father should take his loss by selling his property on the open market and purchase an annuity with some other asset.

Where the annuity is created under circumstances that make it the equivalent of cash, the reasons for deferral of gain or loss disappear. The transfer of property to an organization that has a degree of financial solvency, such as a corporation, trust or a foundation that from time to time issues annuities, is a taxable exchange.[6] This same reasoning could be extended to annuities issued by closely held corporations, or by family trusts. The solvency of the corporation, or the fiduciary nature of the trust relationship make such annuities closer to cash than an annuity promised by a mere individual. As yet, there are no cases on this issue.

Any device which would tend to make the annuity payments secure would also tend to make the annuity the equivalent of cash. Thus, mortgages on the transferred property and other security devices should be avoided.[7] Again, there is no real authority for this proposition. It can only be implied from the rationale of the cash equivalence doctrine and the few rulings in the private annuity area.

Certain specific provisions of the Internal Revenue Code could create gain on the private annuity exchange. Sections 1245 and 1250, concerning the re-capture of depreciation deductions taken on the transferred property, must always be considered. Section 47 requires the recapture of the investment credit in the event of an early disposition of certain property. Since there have been no cases applying these sections to a private annuity transaction, it is unclear just how this gain would be

2. Rev. Rul. 239, 1953-2 CUM. BULL. 53.

3. Hill's Estate v. Maloney, 58 F. Supp. 164 (D. N.J. 1944); Kann's Estate, 174 F.2d 357 (3d Cir. 1949); 1950-2 CUM. BULL. 3, *acquiescing in* J. Darsie Lloyd 33 B.T.A. 903 (1936); Rev. Rul. 239, 1953-2 CUM. BULL. 53.

4. *E.g.*, Cowden v. Commissioner 289 F.2d 20 (5th Cir. 1961).

5. Evans v. Rothensies, 114 F.2d 958 (3d Cir. 1940).

6. Rev. Rul. 136, 1962-2 CUM. BULL. 12.

7. For estate tax consequences of security devices, see text with note 11.

recognized. The father could recognize it at once, upon making the transfer, or periodically, over the life of the annuity, or it could simply reduce the son's basis in the property.

In 1954 and again in 1963, legislation was proposed that would tax the father on his gain, if any, in the year of the exchange. Under the present status of the law, however, it seems quite clear that the typical intra-family annuity transaction does not result in an immediate tax to the father when he transfers appreciated property.

III. ESTATE TAX

Aside from deferral of income taxes, a private annuity transaction effectively removes the transferred property from the father's estate. This rule was stated by the United States Supreme Court:

> Where a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for his lifetime, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent. . . .
>
> In these cases, the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made.[8]

The annuity itself, since it ceases on the death of the father is not included in his estate. However, a joint and survival annuity, payable to another beneficiary following the father's death, or an annuity with a refund feature, will have estate tax consequences under section 2039, and is less advantageous, tax-wise, than a straight-life annuity.

If the father fails to live out his life expectancy, his estate cannot claim a loss deduction because of the annuity transaction. The reasons are that he did not enter into the transaction for profit, and also that he has received the full amount of his bargain regardless of how long he lives.[9] The estate tax saving produced by a private annuity transaction will evaporate unless the proper procedures are followed. An error in valuing either the property transferred, or the annuity itself, could mean that instead of an even exchange, a gift has been made.

If the property transferred is worth more than the annuity received, and if the father dies within three years of the transaction, it is arguable that this excess value was a gift in contemplation of death and thus in-

8. Fidelity-Philadelphia Trust Co. v. Smith, 356 U.S. 274, 280-1, n.8 (1958).

9. Industrial Trust Co. v. Broderick, 94 F.2d 927 (1st Cir. 1938); Helvering v. Louis, 77 F.2d 386 (D.C. Cir. 1935).

cludable in the father's estate under section 2035.[10] Conceivably, the entire transaction could be called a gift in contemplation of death, resulting in total inclusion of the transferred property in the father's estate.

Other ways in which the estate tax saving will be lost are if the annuity payments are keyed into the income produced by the transferred property, or if the transferred property is security for the annuity payments. Aside from the fact that this would probably make the annuity the equivalent of cash, thus triggering income tax consequences in the year of the transaction, the property would probably be included in the father's estate under section 2036 as being property which he transferred while retaining for himself a life estate.[11]

To be an effective tax saving device, the transaction must be one in which the father irrevocably parts with the transferred property and then relies entirely on his son's unsecured promise to make the annuity payments.

It should be pointed out that if the father accumulates the annuity payments rather than spending them, these accumulations will be included in his estate. If the father does not need the annuity for his own support, he could give a part of these payments back to his son each year. If these gifts are within the annual exclusion,[12] there should be no tax consequences at all to such an informal arrangement.

An alternate method of transferring property to the son, while postponing income taxes on the transfer, is the installment sale. For estate tax purposes, however, the present value of the unpaid installment obligations would be included in the father's estate. The annuity transaction is clearly preferable, tax-wise.

A rather sophisticated use of the private annuity has been suggested[13] as an estate tax saving device. The typical estate plan divides an estate into a marital deduction trust and a residuary trust. The marital deduction trust corpus would normally be included in the estate of the surviving spouse. The suggestion is that the marital trust sell its assets to the residuary trust in exchange for an annuity, thus leaving nothing in the surviving spouse's estate. Such a device might well be effective provided that it were not mandatory that the decedent's trustees execute the transaction. In such a case the marital deduction might fail entirely by virtue of the terminable interest rule of section 2056(h).

10. *See* Updike v. Commissioner, 88 F.2d 807 (8th Cir. 1937).

11. *See* Greene v. United States, 237 F.2d 848 (7th Cir. 1956); Cornelia B. Schwartz, 9 T.C. 229 (1947); 1943 CUM. BULL. 2; Tips v. Bass, 21 F.2d 460 (W.D. Tex. 1927) (this case is concerned with § 2037 of the Internal Revenue Code of 1954) (The Code is hereinafter cited by section number only).

12. Section 2503(b) ($6,000 in the case of a joint gift).

13. *Report of the Sub Committee on Private Annuities and Estate Planning*, TRUSTS & ESTATES 952, 961 (Oct. 1963).

IV. GIFT TAX

No gift is made, and no gift tax is payable, where the present value of the annuity is equal to the fair market value of the property transferred.[14] Where the property is worth more than the annuity, a gift to the son results.[15] There are several reasons for avoiding any element of a gift in the transaction.

The most obvious reason is the avoidance of the tax gift. This is necessary only after allowing for the $30,000 lifetime exclusion[16] and the $3,000 annual exemption for each donee,[17] which figures can be doubled if a joint gift tax return is filed.[18]

If a gift is made, the son takes over his father's basis in the property transferred,[19] thus preserving the potential for a capital gains tax. By using the private annuity device, the son purchases the property at its fair market value, taking this cost as his basis.[20] Thus, if the son sells the property, he will realize no gain, and if he holds it, he has a high basis for taking depreciation. This stepped up basis is by no means a certain thing. If the father dies earlier than expected, the son's basis is lowered,[21] whereas if he had inherited the property instead, his basis would be almost surely a high one.[22]

That part of the transferred property constituting a gift would have a basis separate from the rest of the property which was purchased for full value.[23] This requires an allocation of the basis for the gift and non-gift portions. Thus part of the property would generate higher depreciation deductions and lower gain on re-sale than the other part. The best way to deal with these complexities is to avoid making a gift in the first place.

The fact that the transaction is in part a gift could create serious estate tax consequences if the father dies within three years of the transaction.[24]

Also, as will be explained, by making a gift the father reduces his investment in the annuity contract, causing a greater part of each an-

14. It is interesting to note that while recognition of gain on the transaction is deferred because of the inability to value the promise of an individual to pay an annuity, no such problem is encountered for gift tax purposes.

15. Rev. Rul. 119, 1955-1 CUM. BULL. 352. But see John C. W. Dix, *infra* note 42, where no gift resulted.

16. Section 2521.

17. Section 2503(b).

18. Section 2513(a).

19. Section 1015(a).

20. Section 1012.

21. Rev. Rul. 119, 1955-1 CUM. BULL. 352.

22. Section 1014(a).

23. *Supra* note 21.

24. Section 2035. See text accompanying note 10.

nuity payment to be taxed to him as ordinary income. If the father wishes to make a gift, it should be done entirely separate and apart from the annuity transaction.

It should also be pointed out that a gift results if the father purchases a joint and survivor annuity with the payments going to his wife upon his death. Being a future interest, such a gift would not qualify for the annual exclusion[25] and, as was previously stated, such an annuity has adverse estate tax consequences at the time of the father's death because of section 2039.

V. TAXATION OF THE ANNUITY PAYMENTS

Section 72 of the Internal Revenue Code controls the taxation of annuities. A part of each payment, called the exclusion ratio, is treated as a return of capital and is received tax free. The remainder of each payment is taxed as ordinary income.

The exclusion ratio is determined as follows:

$$\frac{\text{Investment in the Contract (A)}}{\text{Expected Return (B)}} = \text{Exclusion Ratio}$$

"A" is the consideration paid for the annuity which, in a private annuity transaction, is the fair market value of the property transferred.

"B" is the annual payment multiplied by the father's life expectancy as determined by Table I of section 1.72-9.

The exclusion ratio portion of each payment is received tax free[26] until the father has recovered his basis in the transferred property. Thereafter, the exclusion ratio portion is treated as capital gain until[27] the entire fair market value of the transferred property has been received.

At this point, the father has lived out his life expectancy. Additional payments to him represent mortality gain. Some writers suggest that the exclusion ratio which represents mortality gain should be taxed as capital gain. Other writers disagree with this.[28] This writer feels that a strict

25. Section 2503(b).

26. It has been suggested that the exclusion ratio should be treated from the beginning of the contract as being part return of capital and part capital gain, but this seems contrary to the intent of § 72. *See* Ross, *The Private Annuity as a Tax Minimizing Instrument*, 41 TAXES 199 (April 1963).

27. The nature of the gain depends upon the nature of the asset and the purpose for which the property was held (Rev. Rul. 119, 1955-1 CUM. BULL. 352). Naturally, if the property were stock in a collapsible corporation, dealer property, § 306 stock, or § 1245 or § 1250 property, a variety of results are possible. This paper assumes that the property will generate capital gain.

28. *See generally* Goldberg, *Annuities, A Comparative Analysis*, 22 N.Y.U. 22ND INST. ON FED. TAX 1213 (1964); Middleditch, *The Private Annuity*, 24 J. TAXATION 160 (Mar. 1966); Ross, *supra* note 27.

application of section 72 requires that the exclusion ratio be received tax free after the father has recovered the value of the transferred property.[29] As was already discussed, the father's estate cannot claim a deduction for mortality loss in the event of his early death.

The status of the exclusion ratio when the father outlives his life expectancy is unsettled at this time. The excess of each payment over the exclusion ratio is always taxed as ordinary income.

Section 483, which imputes interest to some deferred payment transactions, is specifically made inapplicable to annuities by section 483(f)(5).

VI. Tax Consequences to the Son

Revenue Ruling 55-119[30] sets out the basis rules for the property in the son's hands. For taking depreciation deductions and for determining gain or loss on the sale of the property, the tentative basis of the property immediately after the transaction is the value of the annuity contract, determined under Table I of section 25.2512-5 of the regulations.

If the father outlives his life expectancy, the extra payments made by the son increase his basis in the property. Upon the father's death, the son's basis becomes the sum of the payments he actually made to his father, less depreciation deductions.[31]

If the son sells the property soon after the transaction (he should wait at least six months so that his gain will be long term), his ultimate gain or loss cannot be determined because his true basis in the property will not be known until his father's death. But in the year of sale, while the father is alive, the son's tentative basis for determining gain or loss is as follows:

> For gain—payments already made, plus prospective value of future payments, less depreciation.
>
> For loss—payments actually made, less depreciation.
>
> If the selling price is between these two figures, no gain or loss can be reported. The matter is deferred until the father's death fixes the true basis.[32]

After the son has reported his gain or loss in accordance with his tentative basis, he will continue making annuity payments until his father's

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29. It was the intent of congress that the exclusion ration should remain throughout the period of the annuity payments, even after the father recovers his investment in the contract. H.R. Rep. No. 1337, 83d Cong., 2d Sess. 21 (1954). *See also* Rev. Rul. 508, 1957-2 Cum. Bull. 67.

30. *Supra* note 21.

31. *Id.*

32. *Id.*

death. If the father lives beyond his life expectancy, each extra payment made by the son represents a capital loss on the earlier sale, or it could cause a reduction of any capital gain he had reported.

If the father dies before he has lived out his life expectancy, this reduces the son's basis to the amount of payments he actually made, and the result is that the son must now recognize a capital gain from the earlier sale. If the son had reported a loss on the sale, his father's early death will have no effect at all.[33]

Of course, if the father dies before the son sells the property, the son already knows what his true basis is and the true gain or loss can be easily determined.

If the son doesn't sell the property, the only effect the father's death will have is that the son's basis in the property becomes known. But what if the tentative basis that the son had been using for depreciation purposes, which was based on the assumption that the father would be receiving annuity payments for the period of his expected life, was too high? Does the son have to recognize this excessive depreciation as ordinary income in the year of his father's death? Revenue Ruling 55-119[34] doesn't discuss this problem and there are no cases on point. The result of such a situation is unclear.[35]

Aside from that problem, where the son is still holding the property at the time of the father's death, the only adverse consequence is that if the father dies earlier than expected, the son's basis is lower than was first computed. This reduces the amount of depreciation he can deduct in the future and creates the potential for capital gain on a later sale.[36] If the father lives longer than expected, the son's basis is raised by the amount of extra annuity payments,[37] thus reducing the possibility of capital gain on a later sale.

Prior to the father's death, the son can use the tentative basis for figuring depreciation on the property. If the father outlives his life expectancy, each additional annuity payment adds to the son's basis, thus giving him a greater amount of depreciation. The father's death fixes the

33. *Id.*

34. *Id.*

35. Section 1245 does not seem applicable here. The father's death is not a "disposition" that would trigger the depreciation recapture provisions of that section. Possibly a basis adjustment is all that would be required.

36. If the transaction is treated as a venture for profit, the father's early death could cause the son to recognize income. *See* Donald H. Sheridan, 18 T.C. 381 (1952); Rev. Rul. 119, 1955-1 CUM. BULL. 352; John C. Moore Corp., 15 B.T.A. 1140 (1929), *aff'd*, 42 F.2d 186 (2d Cir. 1930). These cases have not been relied on by the service, and, since Rev. Rul. 239, *supra* note 1, and Rev. Rul. 119, *supra* note 20, it has been thought that the venture for profit theory will be applicable only where private annuities are purchased for cash.

37. *Supra* note 21. If the venture for profit theory is applicable such additional payments should be deductible. The loss will be ordinary or capital, depending on the son's trade or business. Section 166.

son's basis at the total of the payments made to him, less depreciation already taken.[38]

Generally, since the parties will be related, the "bonus depreciation" of section 179 will not be allowed.[39] Similarly, the investment credit would be unavailable.[40]

The "double declining balance" and "sum of the year's digits" methods of depreciation will not be available since the original use of the property will not commence with the son.[41] The son could take advantage of section 167(f) which permits a reduction in the salvage value of the property, thereby increasing the amount of the property that can be depreciated.

It is well established that no part of the annuity payments are deductible as interest. The entire amount of each payment is regarded as a capital expenditure.[42] This is true even though a part of each payment is taxed to the father as interest under section 72.

VII. VALUATION

Revenue Ruling 55-119[43] directs that Table I of the Estate and Gift Tax Regulations[44] be used in valuing the annuity given in the transaction. This table has been criticized because it ignores the difference in life expectancy between males and females, while the tables in 1.72-9 take note of such differences. Also, Table I is based upon lower life expectancies than the tables in 1.72-9 and in Revenue Ruling 62-137.[45] It has never been clear whether or not 55-119, which was applicable to the Internal Revenue Code of 1939, has any applicability to the present code.

The recent Tax Court case of *John C. W. Dix*[46] has cleared up some of this confusion. In that case the taxpayer had sold securities which he had acquired from his parent in a private annuity transaction. He claimed that the securities had a high basis because the annuity he gave in exchange was worth as much as an annuity issued by a commercial insurance company, and that, therefore, he realized no gain when he sold the securities.

The Tax Court said, "The litigated cases overwhelmingly recognize the valid distinction between the valuation of private annuities and an-

38. *Supra* note 21.
39. Section 179(c)(2)(A).
40. Section 48(c).
41. Section 167(c)(2).
42. John C. W. Dix, 46 P-H TAX CT. REP. & MEM. DEC. 569 (1966).
43. *Supra* note 21.
44. This table is found in Treas. Reg. §§ 20.2031-7 and 25.2512-5.
45. This is for valuing so-called semi-private annuities discussed in the companion ruling 62-136, *supra* note 6.
46. *Supra* note 42.

nuities issued by commercial life insurance companies and have upheld the . . . regulations for valuing private annuities."[47]

The taxpayer then argued for the next highest value by trying to use the tables in section 1.72-9, but the Tax Court found no merit in this approach. It said that those tables are based on the experience of commercial insurance companies and are not applicable to private annuities. Furthermore, the Court stated that the tables apply only to amounts *received* as annuities, while the issue here was the amount *paid* as an annuity.

The Tax Court applied Revenue Ruling 55-119 to the transaction and held that Table I had to be used in valuing the annuity. This caused the taxpayer to have a low basis in the securities and meant that he had realized a gain on their sale.[48]

This case illustrates the importance of correctly valuing the annuity. Equally serious is the problem of valuing the property transferred by the father. Where the property consists of securities traded on an exchange, valuation is obviously no problem. For other assets, the value should be accurately and convincingly established. When necessary, independent appraisers should be used to make the valuation one that may be safely relied on.

As previously discussed, the annuity payments should never be measured by the income from the property transferred.[49]

VIII. PROPERTY TO BE TRANSFERRED

Careful consideration should be given to the property to be transferred. *Cash* should not be used. There is too great a danger that the venture for profit theory will cause the son to be taxed on his windfall in the event that the father dies earlier than expected.[50] Although there is no case directly on this point, prudence requires that the issue be avoided, particularly in view of the greater advantages inherent in using other property.

Property which has *appreciated* in value is the most logical choice since the capital gains tax is deferred, and perhaps avoided entirely by the father. The disadvantage inherent in this is that if the father dies early, the son's basis is lowered, whereas if the son inherited the property, his basis would definitely be the property's fair market value. Clearly, the transaction is worthwhile where the father's estate tax bracket is

47. *Id.* at 573.

48. Although the securities transferred had a fair market value in excess of the value of the annuity given in return, the court found that no gift had been intended.

49. *See* text accompanying note 11 *supra*.

50. *See* note 36 *supra* and accompanying text.

higher than the 25% capital gains tax which the son might one day have to pay if he sold the property while it had a low basis in his hands.[51]

Also, using appreciated property gives the father the benefit of a high exclusion ratio for his annuity payments, while at the same time deferring the capital gains tax on the appreciation.

Since the father cannot take a deduction for any loss realized on the exchange, it is suggested that he avoid using property that has declined in value for the annuity transaction.

Regarding the use of *depreciable* property, the problems this creates with regard to the son's basis in the property have already been discussed. However, the use of depreciation deductions adds to the son's cash flow and assists him in being able to make the annuity payments. Also, if the property has appreciated in value, the son's stepped up basis enables him to a larger depreciation deduction than his father could take. But the father's early death could wipe out this advantage and, indeed, could cause gain to be recognized to the extent of any excess depreciation based on the erroneously high tentative basis established at the time of the original transaction. Using non-depreciable property avoids these uncertainties.

The simplest and most advantageous property to use is appreciated securities.[52] This gives all the advantages of the private annuity and avoids most of the uncertainties.[53] Further, it provides an excellent method of passing a family business on to the next generation without the imposition of estate or gift taxes.

IX. Other Aspects

One often suggested plan is that the son hold the transferred property for six months (to make any gain he may have to recognize long-term) and then sell it, investing the proceeds in mutual funds. Then he elects a withdrawal program such that his return from the fund is equal to the annuity payments he is obligated to make. This seems perfectly safe and, so long as there is no need to keep the transferred property in the family, as would be the case if the property were stock in the family business, it is the most logical thing for the son to do.

51. Without a marital deduction, a taxable estate of $50,000 (after the $60,000 exemption) is in the 25% bracket. Between $100,000 and $250,000, a taxable estate is in the 30% bracket.

52. As for the use of § 306 stock, see Rev. Rul. 328, 1957-2 Cum. Bull. 229, where it is stated that § 306 stock may be safely donated to a charity without ordinary income consequences to the donor, while giving him a full charitable deduction. The charity, of course, is unconcerned that this is § 306 stock, since it is tax exempt. The device would not be feasible between members of a family because the § 306 stock retains its character in the transferee's hands, and would generate ordinary income when sold.

53. Uncertainties such as: tentative basis for depreciation, possible investment credit recapture on "early disposition," uncertain application of §§ 1245 and 1250.

But the son should not simply endorse his check from the fund and hand it over to his father. Rather, he should deposit the check in his own account and make his annuity payment a separate transaction. This avoids the appearance of a pre-arranged plan whereby the father has retained the right to keep the income from the transferred property.

The father may wish to make an annual gift to his son in the amount of income tax the son has incurred from the transferred property. This also seems perfectly permissible, but care should be taken that the appearance of a pre-arranged plan be avoided.

For example, if on the last day of the year, the son endorses his check from the mutual fund, hands it over to his father, and receives from his father a check which exactly pays the son's income tax on the fund dividends, it certainly looks as if the original exchange was a mere sham, and it could be argued that the fund is really the father's property, with its income taxable to him, and the principal includable in his estate.

To avoid this, the receipt of income from the property and the making of annuity payments should be handled by the son as separate events on separate dates, and any gifts the father wishes to make should appear to be unrelated, in time and amount, to the annuity arrangement.

The son should not place the transferred property in a trust for his father. Revenue Ruling 62-136[54] could be extended to this arrangement, causing the immediate realization of income by the father, in addition to the possibility that the entire transaction could be regarded as a sham, having no effect at all, or that the father has really made the transfer, but has retained a life estate.

It is obvious that the son should not give notes to his father to secure the annuity payments. Also the son shouldn't agree in writing to any restraints on his right to dispose of the transferred property.

Insurance may be used by the parties and, if care is taken, the advantages of the transaction will be preserved. The following are situations where insurance may be desirable:

1. Where the son has sold the transferred property while his father is alive, thus running the risk of a capital gains tax in the event his father dies early, the son may want to purchase decreasing term insurance on his father's life, naming himself as beneficiary, to provide the funds to pay this potential tax.

2. If the son is receiving the bulk of his father's property in exchange for the annuity, he may in effect be disinheriting his sister. Thus, the father may insist that the son purchase insurance on the father's life naming his daughter as beneficiary, and thereby equalize the financial status of his children.

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54. *Supra* note 6.

3. The son's estate will be obligated to make annuity payments to the father, where the father outlives the son. The son could provide for this contingency by purchasing insurance on his own life, so that his estate will be able to meet this burden.

4. The father may want to buy insurance on his own life merely to prove that he is a standard risk and that the valuation of the annuity is therefore a fair one.

X. Conclusions

The greatest drawback to a private annuity transaction is the fact that anything that would tend to secure the payment of the annuity, by giving the father a claim on the transferred property or its income, would also tend to defeat the two basic advantages of the arrangement. Taxation of gain on the exchange is deferred only where the son's promise to pay the annuity is unsecured; and the property is removed from the father's estate only if he irrevocably disposes of it and its income at the time of the exchange.

The annuity payments will almost always exceed the income from the property, creating a cash problem for the son. Also, the son will be paying taxes on this income, while turning it all over to his father. The son cannot take an interest deduction, while a part of each payment is taxed to the father as ordinary income.

If the father lives too long, the son will pay too high a price for the property; while if the father dies too soon, the son's basis is lowered, thus locking in the potential for capital gains tax.

However, it must be remembered that the son gets the property immediately, at a stepped up basis which, although tentative, has a good chance of remaining high. The capital gains tax will be deferred and the property will be removed from the father's estate.

High depreciation which can be taken by the son, and the favorable method under which the father is taxed on the annuity payments are additional advantages.

For the father who trusts his son, and for the son who can afford to pay his father an annuity, the intra-family private annuity is a most alluring device.

COMPARISON OF METHODS OF TRANSFERRING STOCK FROM FATHER TO SON

	Father's Capital Gains Tax	Father's Gift Tax	Father's Estate Tax	Treatment of Payments to Father	Property Received by Son	Basis to Son	Son's Capital Gains Potential
1) Father holds the stock until he dies.	0	0	$30,000	$4,000 ordinary income	$ 70,000 inherited	$ 70,000	0
2) Father sells the stock on the market and invests the proceeds. (after taxes)	$20,000	0	$24,000	$3,200 ordinary income	$ 56,000 inherited	$ 56,000	0
3) Father gives the stock to his son.	0	$9,225	0 Unless § 2035 Applies	0	$100,000 by gift	$ 29,225	$69,775
4) Father sells the stock to his son on the installment basis, payable over 10 years.	$ 2,000 each year for 10 yrs.	0	All unpaid installment obligations are in his estate.	$10,000 a year for 10 yrs. plus interest. $8,000 is capital gain $2,000 is return of capital.	$100,000 by purchase	$100,000	0
5) Private annuity transaction.	0 Until exclusion ratio receipts exceed $20,000	0	0	$10,490 for life, of which $3,730 is ordinary income. $6,760 (exclusion ratio) is free up to $20,000, and then capital gain from $20,000 to $100,000 and probably free thereafter.	$100,000 by purchase	$100,000 Tentative	0 Tentative

This chart is based on the following assumptions: The father is age 65, and in the 30% Estate Tax bracket. The stock cost him $20,000 and is now worth $100,000. His investments yield 4%. He has already used up his $30,000 lifetime exemption for gift tax purposes. His estate will not take a marital deduction. Capital gains will always be taxed at 25%.