WRMarketplace
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The *WRMarketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led ***by Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca Manicone. WRMarketplace* #17-21 was written by Greenberg Traurig Shareholder Karen D. Yardley.**

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TOPIC: Private Annuities – Managing the Exhaustion Test.

MARKET TREND: Private annuities may provide certain individuals with an effective tool for multi-generational legacy planning.

SYNPOSIS: Transferring assets to a grantor trust in exchange for a private annuity can transfer a family legacy while providing the individual with a fixed income stream for life to manage lifestyle expenses. In particular, this planning may be considered for an individual who has a shortened life expectancy but is not terminally ill. A private annuity for life approach, however, requires additional planning to avoid the exhaustion test, which requires that the trust have sufficient funds to pay the annuity until the annuitant reaches age 110. Failure to pass the exhaustion test can result in a taxable gift, reduction of the present value of the annuity stream, and potential inclusion of the transferred assets in the individual's estate. Options for planning for the exhaustion test include pre-seeding the grantor trust or using an existing, well-funded grantor trust, obtaining personal guarantees, and/or limiting the annuity to the shorter of life or a term of years.

TAKE AWAYS: Private annuities can help preserve illiquid assets, like family businesses, for the next generation, while providing the annuitant with a fixed income stream. Heightened regulatory interest in, and the structuring intricacies of, private annuities, emphasize the importance of having a team of skilled advisors who can collaborate to properly document, implement, and maintain this complex planning approach. Key components include ensuring the value of the annuity obligation matches the fair market value of the assets sold, evidencing that the trust has sufficient ability to re-pay its obligations, complying with all payment terms, and enforcing the grantor's rights in the event of non-compliance.

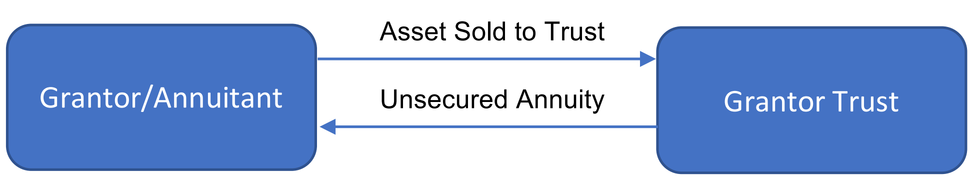
PRIOR REPORTS: 15-09.

MAJOR REFERENCES: Treas. Regs. §25.7520-3.

While the sale of assets to a grantor trust in exchange for an installment note is frequently used to remove assets from an individual's estate, it may not be the optimal structure for an individual who has a shortened life expectancy or desires a guaranteed income stream. For such individuals, the sale of assets to a grantor trust in exchange for a private annuity for life may provide a better option. While private annuities can provide many advantages, they present unique issues that require careful analysis.

WHAT IS A PRIVATE ANNUITY?

A private annuity is a type of estate freeze transaction which, in the right situation and when properly structured, can transfer future appreciation on assets sold to the next generation. In a typical private annuity transaction, an individual transfers assets to a grantor trust in exchange for the trust's ***unsecured*** obligation to make fixed annuity payments to the individual (creator) for the remainder of his life. The annuity obligation terminates upon the individual's death, so that, arguably, nothing is included in the individual's estate for estate tax purposes.



To not make a gift, the actuarial present value of the annuity (based on the grantor's life expectancy under the IRC § 7520 tables) should equal the fair market value ("**FMV**") of the assets sold. Because the sale is to a "grantor" trust, the sale is disregarded for income tax purposes and does not result in capital gain (the assets sold, however, will have a carryover basis for income tax purposes in the hands of the trust). Income earned on the assets will be reported by the grantor/annuitant on his personal income tax returns, allowing the assets to grow subject to the annuity payments, but without reduction for income tax payments. Further, if the annuitant dies prior to his anticipated life expectancy, the obligation to pay the annuity effectively ceases early. On the other hand, the trust could end up paying more than the FMV of the acquired assets if the annuitant lives beyond his life expectancy, a matter beyond the annuitant's control. Generally, a private annuity works best for an individual who has:

- A shortened life expectancy but more than a 50% chance of surviving at least one year (i.e., is not "terminally ill" as defined in the Treasury Regulations).[i]

- A desire for a fixed income stream for lifestyle needs.

- An estate that is exposed to tax.

- A business and/or other assets that produce income or are anticipated to appreciate rapidly.

- Other assets and sources of income apart from the assets transferred.

  Example: Alan, age 75, transfers stock of an S corporation valued at $1,000,000 to a grantor trust for the benefit of his children, in return for an annuity which pays $107,918 annually to Alan for the rest of his life. He dies four years later. Because the annuity obligation ceased at Alan's death, the trust is not obligated to make the remaining annuity payments. The trust receives the stock and any appreciation for a cost of $431,672, saving $568,328.

THE EXHAUSTION TEST

Typically, private annuities are structured to provide payments for the annuitant's life. To prevent a taxable gift, the value of the annuity received must equal the FMV of the asset sold. The mortality tables promulgated under IRC § 7520 can be used to determine the annuitant's life expectancy and the annuity factor used to calculate an annuity. However, if the annuity is paid from a trust, the trust also must satisfy the so-called "**exhaustion test**" under the Treasury Regulations.[ii] ***Under the exhaustion test, the trust must have sufficient funds to make all annuity payments until the annuitant attains age 110***.

The safe harbor under the Treasury Regulations provides that if the annuity, as a percentage of the fund available to satisfy the annuity, is less than or equal to the applicable IRC § 7520 interest rate (the IRC § 7250 AFR for the effective date of the sale), then the annuity is presumed to satisfy the exhaustion test.[iii] If, however, the annuity exceeds the IRC § 7520 interest rate, then it is presumed that the annuity will deplete the funds available for payment of the annuity, thus failing the exhaustion test. Failure causes the annuity to be subject to a separate valuation procedure[iv], resulting in a reduced value for the annuity and a taxable gift to the trust, along with possible inclusion in the grantor's gross estate for estate tax purposes under IRC § 2036; a substantial risk.

> *Example*: Again, Alan, age 75 and in poor health (but not terminally ill), transfers stock of an S corporation valued at $1,000,000 to a grantor trust for the benefit of his children, in return for an annuity which pays $107,918 annually to him for his lifetime. Pursuant to the mortality tables, Alan is expected to live to age 87 (another 12 years). The trust has no other assets. The applicable IRC § 7520 interest rate is 2.4%. The annuity, as a percentage of the trust's funds available to satisfy the annuity, exceeds the applicable IRC § 7520 interest rate. Accordingly, the trust fails the exhaustion test, with the final full annuity payment made in year 10 and a partial payment of $65,672 made in year 11. Because the trust arguably lacks sufficient funds to support the annuity through age 110, the annuity is valued at $775,036, resulting in a taxable gift of $224,964.

MANAGING THE EXHAUSTION TEST

Ensuring the private annuity is able to meet the exhaustion test requires careful structuring and analysis. While it may be tempting to simply accept the result of the exhaustion test and file a gift tax return to report the gift, there is still a high risk that such approach would be deemed a transfer with a retained interest under IRC § 2036, pulling the assets into the annuitant's taxable estate. Accordingly, other options must be explored to provide additional funds to support payment of the annuity.

Seed Gifts. If the grantor has sufficient assets and remaining gift tax exemption, the grantor can pre-fund the grantor trust with sufficient assets to satisfy the exhaustion text. Using a "**seed**" gift to provide sufficient capitalization for the trust may require a substantial gift. In the above example, a seed gift of $1,536,007 would be required to satisfy the exhaustion test, resulting in total available funds of $2,536,007 for payment of the annuity.

Seed gifts to the grantor trust should be separated by time (by at least 30 days but preferably a longer period of time) from the private annuity transaction to minimize the possibility that the gift and annuity transaction are collapsed into a single transaction and deemed to be a gift with a retained interest.

Existing, Well-Funded Grantor Trust. Another strategy for dealing with the exhaustion test is using a pre-existing grantor trust that already has substantial value. Such a trust eliminates the need for a seed gift and minimizes the exposure to the possibility of collapsing the private annuity.

Guarantees. Guarantees from trust beneficiaries or third parties also can provide an additional source of funds for managing the exhaustion test. Critical to using guarantees is structuring them as viable and legally enforceable, meaning that:

- The guarantees must be in writing;

- Each individual issuing a guarantee is represented by separate counsel;

- The individuals issuing the guarantees are paid an annual fee for the guarantees; <u>and</u>

- Each individual providing a guarantee is creditworthy and has the ability to pay the guaranteed amount if called upon to do so.

Annuity for Shorter of Term or Life. As a variation on the annuity for life, the private annuity could be structured for the shorter of life or a term of years. Limiting the term of the annuity to a maximum number of years cuts off the excess years required under the exhaustion test and reduces the amount required to support the annuity payments.

> *Example:* Alan, age 75, transfers stock of an S corporation valued at \$1,000,000 to a grantor trust for the benefit of his children, in return for an annuity which pays \$107,918 annually to Alan for the shorter of his lifetime or 13 years (Alan's life expectancy is 12 years). The applicable Section § 7520 interest rate is 2.4%. Because the term is limited, the \$107,917 annuity zeros out the gift without regard to the exhaustion test. The amount necessary to fund the annuity for 13 years is \$1,385,996. The excess required to fully endow the annuity can be funded with a seed gift or personal guarantees of \$385,996.

Note the term selected should be slightly longer than the annuitant's anticipated life expectancy to circumvent possible recharacterization of the annuity as a sale in exchange for a self-cancelling installment note ("**SCIN**") which requires a risk premium and could trigger gift and estate tax consequences.[v]

BEWARE: OTHER PLANNING CONSIDERATIONS

The IRS has heightened its scrutiny of grantor trust sales transactions, including private annuities. Private annuities make sense for individuals who understand the risks and work with a team of skilled advisors who collaborate to properly document, implement, and maintain the annuity arrangement. When structuring a private annuity, carefully consider the following factors in addition to the exhaustion test:

- The standard annuity tables under IRC § 7520 may only be used if the annuitant is not terminally ill (i.e., has more than a 50% chance of surviving at least one year). If the annuitant is in poor health, carefully document his chances of surviving at least a year.

- The grantor and the trust must follow all formalities, including documenting and recording asset transfers, making timely annuity payments, assuring proper tax reporting, etc. The grantor must take prompt action to enforce his rights if annuity payments are not timely made.

- Ensure a minimum of 30 days between the sale of the annuity and any seed gifts to fund the trust, but longer is better. This should help offset the potential argument to collapse the two transfers into a single gift with a retained life interest, which would bring the assets back into the grantor's estate.

- Annuity payments should be fixed and should not be contingent on the investment performance of, or income generated by, the asset sold or the trust's overall performance. Annuity obligations should be payable from the entire trust principal.

- Private annuities can create a "windfall" to the trust beneficiaries if the grantor dies early in the annuity term. Expect IRS scrutiny if the seller dies unexpectedly.

- If the grantor outlives his life expectancy, then the trust will pay more than FMV for the assets sold, returning growth and income to the grantor's estate.

TAKE AWAYS

Private annuities can help preserve illiquid assets, like family businesses, for the next generation, while providing the annuitant with a fixed income stream. Heightened regulatory interest in, and the structuring intricacies of, private annuities, emphasize the importance of having a team of skilled advisors who can collaborate to properly document, implement, and maintain this complex planning approach. Key components include ensuring the value of the annuity obligation matches the fair market value of the assets sold, evidencing that the trust has sufficient ability to re-pay its obligations, complying with all payment terms, and enforcing the grantor's rights in the event of non-compliance.

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NOTES

[i] Treas. Regs. § 25.7520-3(b)(3).
[ii] Treas. Regs. § 25.7520-3(b)(2)(i).
[iii] *Id.*
[iv] *Id.* See also, § 25.7520-3(b)(2)(v), Example 5.
[v] SCINs are installment sales with an automatic cancellation provision that terminates the repayment obligation if the seller dies before the end of the note's term. The self-cancellation feature arguably removes the note's value from the seller's estate for estate tax purposes. To not make a gift, the SCIN's FMV must equal the property sold plus a "**risk premium**," such as a higher purchase price for the asset, a higher interest rate for the note, or some combination thereof, to account for the possibility of early termination. Because of the note's mortality feature, SCIN valuations often rely on the actuarial tables under IRC § 7520 to determine both the risk premium and overall value and may result in higher payments than would be required for a private annuity for life.