Marquette Elder's Advisor

Volume 7
Issue 2 *Spring*

Article 3

Spring August 2012

Maximizing the Benefits of Estate Planning Bet-to-Die Strategies: CLATS and Private Annuities

Peter Melcher

Matthew Zuengler
Marquette University Law School

MAXIMIZING THE BENEFITS OF ESTATE PLANNING BET-TO-DIE STRATEGIES: CLATS AND PRIVATE ANNUITIES

Peter Melcher* and Matthew Zuengler**

INTRODUCTION

Estate planners commonly encounter clients with life expectancies far shorter than average for someone the clients' age. Tragic as this may be, it provides unique estate planning opportunities. By using an appropriate bet-to-die strategy, such a client can transfer assets to beneficiaries at a small fraction of what the normal transfer tax cost would be. These strategies are effective because they enable the taxpayer to greatly undervalue transferred property interests for federal transfer tax purposes.

In this article, we will first provide a general explanation of how life interests in property are valued for transfer tax purposes, why the IRS is generally powerless to prevent undervaluation in certain circumstances, and the extent to which interests can be undervalued. Then, we will discuss the key bet-to-die strategies – charitable lead annuity trusts (CLATs) and private annuity sales – explaining their basic operation, how they produce economic benefits, and their advantages and

* Peter Melcher, J.D., L.L.M., M.B.A., is a Senior Tax Consultant at Virchow Krause & Company in Milwaukee, Wisconsin, Associate Editor of the Journal of Retirement Planning and a frequent contributor to national estate and retirement planning journals.

** Matthew C. Zuengler is a partner with the law firm of Hager, Dewick & Zuengler, S.C., located in Green Bay, Wisconsin. He received a B.S., cum laude, in Economics and Finance from Carroll College and a J.D. from Marquette University Law School.

disadvantages.[1]

VALUING LIFE INTERESTS IN PROPERTY—THE IRS'S DILEMMA

Estate planners commonly divide property ownership between (a) a life estate or life annuity interest and (b) a remainder interest to allow for the transfer of one or the other to a beneficiary. Because lifespans vary considerably, it is never possible to value these interests precisely for transfer tax purposes. This creates a dilemma for the IRS and the courts in deciding how these interests should be valued. One alternative would be to conduct a thorough examination of all the facts and circumstances every time a taxpayer made a transfer.[2] This might involve looking at the taxpayer's medical history, investigating the longevity of ancestors, and obtaining an opinion from the taxpayer's current physician. While this might produce the most accurate valuation possible, it would place an unreasonable burden on the IRS and the courts.[3]

The only alternative to this subjective and time-consuming

---

1. Sales of remainder interests, split purchases, and self-canceling installment notes (SCINs) are also sometimes mentioned as bet-to-die strategies. Sales of remainder interests and split purchases have limited application, however, because they are subject to I.R.C. § 2702 and can only be used effectively if the transaction falls within an exception to § 2702 (i.e., transactions involving persons other than close family members or transfers of a personal residence). I.R.C. § 2702 (Westlaw through 2006 legislation). SCINs would produce extremely favorable economic consequences if the seller died prematurely, but using them as a bet-to-die strategy may be risky because they do not qualify for the safe harbor provided in the I.R.C. § 7520 regulations. As explained more fully below, life annuities can be valued by reference to standard IRS actuarial tables whenever the person who is the measuring life has more than a fifty percent chance of surviving for more than one year, but the regulations do not apply to self-canceling installment notes. The IRS takes the position that in valuing SCINs it does not have to use the average life expectancy for a person of the seller's age, but can look at the seller's health to determine his or her actual life expectancy. *See* Gen. Couns. Mem. 39503 (June 28, 1985), WL 373070. As a result, it scrutinizes SCIN transactions carefully to make sure that taxpayers are not overvaluing the note based on the likelihood that the seller will die early. The authors have firsthand experience with this IRS policy, having received requests for medical information relating to clients who have made sales using SCINs. While a strong argument could be made that the administrative necessity rationale requiring the IRS to apply its standard tables to life annuities should also apply to SCINs, we will limit our discussion to CLATs and private annuities because the use of these techniques as bet-to-die strategies is firmly grounded in Treasury regulations.

2. *See* Ithaca Trust Co. v. U.S., 279 U.S. 151, 155 (1929).

3. *See id.*

analysis would be to use actuarial tables based on average life expectancies to provide a bright-line rule.[4] Annuities, life estates, remainders, and reversions are generally valued by reference to the tables prescribed in Internal Revenue Code (I.R.C.) section 7520, which reflect mortality data for the population as a whole and produce values appropriate for a transferor with an average life expectancy.[5] If the transferor's actual life expectancy is substantially different, however, the transferred interests could be greatly overvalued or greatly undervalued. This would not be a problem if there was no selection bias in choosing the measuring lives for valuing the transferred life estates, life annuities, and remainder interests. Most interests would be assigned a value reasonably approximating their true value. Some interests would be substantially undervalued or overvalued, but the IRS would come out about even in the long run.

Unfortunately for the IRS, however, measuring lives are not selected at random. Some transfers of life interests favor taxpayers with a longer-than-average life expectancy and others favor taxpayers with a shorter-than-average life expectancy.[6] The former are sometimes referred to as bet-to-live strategies[7] and the latter as bet-to-die strategies. Given a particular client's circumstances, estate planners can recommend an appropriate strategy to take advantage of the actuarial tables. Because bet-

4. *Id.*

5. I.R.C. § 7520 (Westlaw through 2006 legislation). We are referring to the transferor here for clarity of presentation. Note that the person who is the measuring life could be someone other than the transferor.

6. *See* McMurtry v. Comm'r, 203 F.2d 659, 667 (1st Cir. 1953).

7. An example of a bet-to-live strategy is a charitable remainder annuity trust (CRAT). To illustrate how it can be used to create transfer tax benefits, suppose that taxpayer (T) (age sixty and in excellent health) transfers property worth $1,000,000 to a CRAT. The CRAT is to pay T an annuity of $60,000 per year for T's life with the remainder interest passing to charity. The actuarial life expectancy for a sixty year-old is about twenty-one years, so on average T could expect to receive about twenty-one annuity payments. If T lives for twenty-one years, it will turn out that the life annuity and the charity's remainder interest were properly valued. If T lives for thirty-one years, however, he will receive ten extra payments. This means that T's lead interest will turn out to have been undervalued and the charity's remainder interest overvalued, basically giving T a charitable deduction for value that T ended up retaining.

to-die strategies now offer much greater planning opportunities, they will be our focus in this article.

A simple example can be used to introduce the concept of bet-to-die strategies. Suppose that a taxpayer has an actuarial life expectancy of about twenty-five years, but has a medical condition that reduces her actual life expectancy to only four years. The taxpayer transfers assets worth $1,000,000 to her children in exchange for a life annuity having the same $1,000,000 value. Suppose further that, using the standard IRS mortality tables and interest rate assumptions, the amount of the annual payments is $80,000 per year. If the taxpayer lives to her actuarial life expectancy, the value of the property transferred and the present value of the annuity stream will be about equal. If she lives for only four years after making the transfer, however, she will transfer $1,000,000 and take back only $320,000, removing $680,000 from her estate on a tax-free basis.[8] Estate planners can select which taxpayers will use private annuity sales, recommending it to individuals like this taxpayer but not to others who may have an actual life expectancy of twenty-five, thirty or thirty-five years. This leaves the courts and the IRS with a difficult problem. How can the need for administrative convenience be reconciled with the need to prevent massive tax avoidance?

THE RESPONSE OF THE COURTS

Long ago the courts recognized that the general use of actuarial tables to value most life estates, life annuities, and remainder interests was an administrative necessity.[9] The alternative, a comprehensive analysis of the health of the transferor, was generally rejected as unworkable.[10] Thus, the public policy in favor of administrative convenience generally

8. This simple example is meant only to introduce the concept of bet-to-die strategies. We will present a more complete explanation of the tax savings when we consider the various strategies in detail below, taking into account present value concepts and methods of increasing the transfer tax savings.

9. *Ithaca Trust*, 279 U.S. at 155; Simpson v. U.S., 252 U.S. 547, 550-51 (1920).

10. *Ithaca Trust*, 279 U.S. at 155.

came to outweigh concerns about taxpayers with shorter-than-average life expectancies taking advantage of the tables. Using the tables was necessary even if it occasionally produced inaccurate valuations.[11]

At the same time, the courts realized that taxpayers could go too far, and that use of the tables was improper in extreme cases.[12] Thus, the issue for the courts was how short a person's actual life expectancy had to be to justify departing from the tables and using the actual life expectancy instead.[13] Historically, the courts permitted the tables to be disregarded only if actual life expectancy was *brief*[14] and death was *"imminent or predictable"*[15] or if it was *"unmistakable to one in possession of the facts that the [individual's] life would be radically shorter than predicted in the actuarial tables . . . ."*[16] In quantifying this standard, most courts held that actual life expectancy had to be one year or less.[17] In some earlier cases, the Tax Court applied an even more stringent standard, requiring that it be reasonably certain that the person in question would not live for more than one year.[18]

Ultimately, the case law was codified into I.R.C. section 7520 regulations in 1989. These regulations apply to life estates, interests for a term of years, annuities, and remainder interests.[19] They provide that the IRS must use the tables prescribed under section 7520 unless the transferor has an "incurable illness or other deteriorating physical condition," resulting in a fifty

11. Bank of California v. U.S., 672 F.2d 758, 760 (9th Cir. 1982); Continental Illinois Bank & Trust Co. of Chicago v. U.S., 504 F.2d 586, 594 (7th Cir. 1974); *McMurtry*, 203 F.2d at 667.

12. *Bank of California*, 672 F.2d at 759-60; *Continental Illinois Bank*, 504 F.2d at 592-93; Estate of Lion, 438 F.2d 56, 61 (4th Cir. 1971).

13. *Id.*

14. *Continental Illinois Bank*, 504 F.2d at 590.

15. Estate of Fabric, 83 T.C. 932, 943 (1984) (emphasis added).

16. *Estate of Lion*, 438 F.2d at 62 (emphasis added).

17. *See, e.g., Bank of California*, 672 F.2d at 760; *Estate of Fabric*, 83 T.C. at 942 (both stating that this was the rule in the majority of cases).

18. Estate of Butler, 18 T.C. 914, 919 (1952); Estate of Jennings, 10 T.C. 323, 327-328 (1948).

19. Treas. Reg. § 25.7520-2(a)(1) (2005).

percent or greater chance of dying within one year.[20] The regulations go on to provide that if the person lives for at least eighteen months after the transfer it creates a rebuttable presumption that the fifty percent test was satisfied.[21] The presumption can only be overcome by clear and convincing evidence.[22] This means that bet-to-die strategies involving interests covered under the section 7520 regulations can be extremely favorable when the person who is the measuring life is likely to live for more than eighteen months, but will likely die well before reaching his actuarial life expectancy.[23] An ideal candidate might be someone who is relatively young, say fifty, with an illness that is likely to shorten his actual life expectancy to perhaps three or four years. Care should be taken to document that, as of the transfer date, the taxpayer had more than a fifty percent chance of surviving for more than one year. A statement by the taxpayer's long-time physician to this effect would carry substantial weight. If the taxpayer survived for more than eighteen months, the IRS would have a very difficult time overcoming the presumption.[24]

Recognizing the possibility of taking advantage of the tables for certain clients, how does an estate planner determine which strategy to use, and how can the benefits of using that strategy be maximized? We will now address the two techniques in detail.[25]

---

20. Treas. Reg. § 25.7520-3(b)(3) (2005).

21. *Id.*

22. *Id.*

23. Treas. Reg. §§ 25.7520-2(a)(1), 3(b)(3) (2005).

24. *See* Gregory A. Hayes & Edward F. Krzanowski, *When IRS Actuarial Tables Don't Apply in Valuing Interests*, 32 EST. PLAN. 21, 26 (2005) (discussing when the IRS actuarial tables need not be applied).

25. *See* T. R. Harris, *Even the Blackest Cloud has a Silver Lining: Wealth Transfer Planning for the Terminally Ill Client*, 1998 University of Miami Heckerling Institute on Estate Planning at Chapter 6 (discussing the use of CLATs, private annuities, and sales of a remainder interest as bet-to-die strategies as well as other planning considerations for clients with a terminal illness; citing Treas. Regs. §§ 1.7520-3(b)(3), 20.7520-3(b)(3), and 25.7520-3(b)(3)).

CHARITABLE LEAD ANNUITY TRUST

When used as a bet-to-die strategy, a CLAT is a split-interest trust that pays an annuity interest to charity for the life of the donor or some other person, with the remainder interest passing to the donor's heirs after his or her death.[26]

BASIC TAX CONSEQUENCES

TRANSFER TAXES

Assuming that the trust is a qualified CLAT, the donor receives a gift tax charitable deduction for the present value of the lead interest, while the present value of the remainder interest is a taxable gift.[27] The value of the remainder interest, for gift tax purposes, is the value of the property transferred to the trust minus the value of the charity's lead annuity interest.[28] The value of the lead interest is calculated by multiplying the amount of the annual payments by the annuity factor that corresponds to the applicable I.R.C. section 7520 rate and the term of the annuity.[29] These annuity factors may be found in IRS publication 1457 or calculated from Table S, found in the regulations under I.R.C. section 2031.[30] As a practical matter, estate planners ordinarily calculate the value of the lead and remainder interests using commercially available software

26. Although the lead interest could also be set for a term of years, this would not produce special economic benefits if the donor died prematurely, because the payments would continue to the charity for the rest of the CLAT's stated term.

27. I.R.C. § 2522(c)(2)(B) (Westlaw through 2006 legislation).

28. *Id.*; *see* Treas. Reg. § 25.2512-5(d)(2)(i) (2005).

29. Treas. Reg. § 25.2512-5(d)(2)(iv)(A) (2005).

30. Treas. Reg. § 20.2031-7(d)(7) (Westlaw thorugh 2005 legislation). Although Table S does not provide annuity factors directly, they can be calculated by subtracting the appropriate remainder factor shown in Table S from one and dividing by the applicable I.R.C. § 7520 rate. To illustrate, suppose that a fifty-five-year-old taxpayer transfers $1,000,000 to a CLAT at a time when the I.R.C. § 7520 rate is five percent. Under these facts, Table S shows a remainder factor of 0.34413. The corresponding annuity factor is [(1-0.34413)/0.05] or 13.1173. *See id.*

programs.[31]

In the case of a term CLAT, the lead interest can be set equal to the full value of the property transferred to the trust, reducing the amount of the taxable gift to zero.[32] It is not possible to zero out a life CLAT, however, because the regulations issued under I.R.C. section 7520 permit the donor to value the charity's annuity payments only up to the time the trust assets would be expected to run out, given the annuity payout rate and assuming that the trust assets produced a total return equal to the I.R.C. section 7520 rate.[33]

Provided that the transfer to a CLAT is a completed gift, all of the transfer tax consequences are ordinarily determined at the time the CLAT is created.[34] This means that there are ordinarily no estate tax consequences when the donor dies.[35]

INCOME TAX

GRANTOR CLAT

If a settlor transfers property to a trust and retains one or more of the powers, including administrative powers, the power to revoke, and the power to control beneficial enjoyment,[36] she will be treated as the owner of the trust for federal income tax purposes.[37] Care must be taken in deciding which powers to retain, however, because most of the listed powers will also cause the transferred assets to be included in the settlor's estate at death under I.R.C. section 2036(a) or 2038.[38] The most

31. Examples of available software include Tiger Tables, offered by Lawrence Katzenstein of the Thompson Coburn law firm in St. Louis, Missouri, and Number Cruncher, a product of Leimberg Associates, Inc. of Bryn Mawr, Pennsylvania.

32. Treas. Reg. § 25.2522(c)-3(d)(2), Ex. 1 (2005).

33. Treas. Reg. § 25.7520-3(b)(2)(i).

34. Treas. Reg. §§ 25.2501-1, 25.2511-2(b) (2005).

35. *But see* I.R.C. § 2035(b) (Westlaw through 2006 legislation) (If the donor does not survive for more than three years after making the transfer, his or her gross estate is increased by the amount of gift tax paid when the CLAT was created.).

36. I.R.C. § 673-77 (Westlaw through 2006 legislation).

37. I.R.C. § 671 (Westlaw through 2006 legislation).

38. I.R.C. §§ 2036(a), 2038 (Westlaw through 2006 legislation).

frequently used power to create grantor trust status for income tax purposes, without causing estate inclusion, is a power to reacquire trust corpus by substituting other property of equal value.[39] Another popular retained power is a power to borrow trust corpus or income without adequate interest or security.[40] In a grantor CLAT, the transferor receives an income tax deduction for the full present value of the lead interest at the time the trust is created, subject to limitations based on adjusted gross income, the type of property contributed, and the type of charity.[41] The transferor is treated as the owner of the trust for income tax purposes, though, and will be taxed on all of the trust's income each year during the term of the trust ,despite the fact that she will receive no distributions.[42]

NON-GRANTOR CLAT

If the grantor retains none of the power discussed in the previous section, the grantor is not responsible for the trust's tax liability. In a non-grantor CLAT, the donor receives no income tax deduction either at the time the property is contributed or at the time the CLAT makes its annuity payments to charity.[43] In a non-grantor CLAT, the transferor is not responsible for the trust's tax liability. The trust is subject to tax on all ordinary income and capital gains, but it receives a charitable deduction for the annuity payments it makes to charity from its gross income.[44] Thus, in effect, the CLAT is taxable only on income in excess of the charitable annuity amount.

---

39. I.R.C. § 675(4)(C) (Westlaw through 2006 legislation).

40. I.R.C. § 675(2) (Westlaw through 2006 legislation).

41. I.R.C. § 170(f)(2)(B) (Westlaw through 2006 legislation).

42. I.R.C. § 170(f)(2)(C). The two amounts do not necessarily cancel each other out, however. The transferor receives the charitable deduction upfront while the income tax liability does not arise until the future, creating a timing advantage. Moreover, the upfront deduction can be applied against ordinary income taxed at rates of up to thirty-five percent, while the income taxed in later years may be capital gains or qualifying dividends taxed at only fifteen percent. *See, e.g.*, Matthew Madsen, *Obtaining a Better Benefit by Using a Grantor Charitable Lead Trust*, 31 EST. PLAN. 579, 579 (2004) (discussing tax advantages of a grantor CLAT).

43. I.R.C. § 170(f)(2)(B).

44. I.R.C. § 642(c) (Westlaw through 2006 legislation).

Regardless of whether the CLAT is a grantor or non-grantor CLAT, the remainder beneficiaries will take a carryover basis in the trust assets upon distribution (i.e., the remainder beneficiaries will have the same basis the transferor had in the assets at the time they were contributed to the trust).[45]

TRANSFER TAX BENEFIT

If the transferor's actual life expectancy is shorter than his or her actuarial life expectancy, the charity will receive fewer payments from the CLAT than the tables assume. As a result, the charitable contribution will be overvalued and the taxable remainder interest will be undervalued. Consider the following example.

EXAMPLE ONE

Assume the following facts:

- Taxpayer (T) transfers assets worth $1,000,000 to a CLAT;
- The applicable I.R.C. section 7520 rate is five percent;
- T is fifty-five years old as of the date of the transfer;
- The annual annuity payments are $76,235.25 and are made at the end of each year;
- T lives for one day after receiving the fourth annual payment;
- The applicable annuity factor is 13.1173, making the value of the lead interest equal to $1,000,000;
- Because of the application of the I.R.C. section 7520 exhausting corpus regulations, however, the amount of the taxable gift is $116,784;[46]
- The total return on the CLAT assets is equal to the I.R.C. section 7520 rate (five percent).

45. I.R.C. § 1015(b) (Westlaw through 2006 legislation).

46. *See* Treas. Reg. § 25-7520-3(b)(2)(i) (providing that payments can only be valued until such time as the trust assets would run out given the amount of the annual payments and assuming that the trust assets produce a total return equal to the I.R.C. § 7520 rate). This computation is illustrated below in the section addressing back-loading payments.

The chart below shows the operation of the CLAT during the four-year period:

Year	Beginning Principal	+ 5% Growth	- Annuity Payment	Remainder
1	$1,000,000	$1,050,000	$76,235	$973,765
2	$973,765	$1,022,453	$76,235	$946,218
3	$946,218	$993,529	$76,235	$917,294
4	$917,294	$963,159	$76,235	$886,923

The amount left in the CLAT at T's death would pass to the remainder beneficiaries with no further tax consequences. Thus, under this scenario, T is able to transfer assets with a value of $886,923 to his children at a transfer tax cost of only $116,784.[47] Assuming a marginal estate tax rate of forty-five percent, the tax payable on the transfer would be only $52,553 (.45 x $116,784).[48] The effective gift tax rate would be only about 5.93 percent ($52,553/$886,923).[49]

POSSIBLE ENHANCEMENTS

There are several potential methods of enhancing the benefits described above:

1. transferring assets that qualify for valuation discounts;
2. transferring assets expected to produce a high total return;
3. using a person with a more favorable life expectancy as the measuring life;

47. If the transferor had sufficient applicable exclusion amount remaining there would be no current gift tax payable, but the $116,784 would be included in the transferor's estate as an adjusted taxable gift. I.R.C. § 2001(b)(1) (Westlaw through 2006 legislation); I.R.S., UNITED STATES ESTATE (AND GENERATION-SKIPPING TRANSFER) TAX RETURN, Form No. 706 (2005) *available at* http://www.irs.gov/pub/irs-pdf/f706.pdf.

48. If T had sufficient applicable exclusion left there would be no tax payable, but when T died his estate would include a $116,784 adjusted taxable gift.

49. We selected four years as the actual remaining lifespan of the donor to demonstrate how dramatic the tax savings could be. While the benefit would diminish as actual remaining lifespan increased, substantial savings would continue to be possible so long as it was significantly less than the remaining lifespan assumed by the IRS in its mortality tables.

4. back-loading payments; and
5. selling to a grantor trust.

DISCOUNTED ASSETS

It is well established in case law that minority interest and lack of marketability discounts may be applied in appropriate circumstances.[50] The assets for which discounts have been permitted include limited partnership interests and fractional interests in real estate.[51] If discounted assets are transferred to the CLAT, the amount of the taxable gift and the amount of the annuity payments will be reduced to reflect the discounted value. Assuming that the CLAT produces sufficient income so that payments do not have to be made in kind, the effect of reducing the amount of the annuity payments will be to leave more in the CLAT for the heirs when the donor dies.[52]

EXAMPLE TWO

Assume the same facts as in Example One, except that a thirty percent discount can be taken on the assets transferred to the CLAT. This reduces the amount of the taxable transfer to $700,000, the amount of the annual payments to $53,365 ($76,235 x 0.7), and the taxable gift to $81,758 ($116,784 x 0.7). As a practical matter, however, the value of the assets to the beneficiaries is still $1,000,000. This is because after the transferor dies, the beneficiaries could be taken out of the partnership wrapper in the case of a family limited partnership or be recombined in the case of fractional interests, thereby

50. *See, e.g.*, Estate of Bonner, 84 F.3d 196, 197-99 (5th Cir. 1996); McCord v. Comm'r, 120 T.C. 358, 376-95 (2003); Estate of Jones, 116 T.C. 121, 131-41 (2001); Knight v. Comm'r, 115 T.C. 506, 517-19 (2000).

51. *Id.*

52. If the CLAT is forced to use discounted assets to make the annuity payments, the benefit of the discounts will be lost. This is because the same discount percentage that was applied to the assets when they were contributed to the CLAT would have to be applied to the assets when they were distributed..

restoring the value of the assets to the undiscounted amount.[53] Again, assuming that cash is used to make the annuity payments, the value left in the CLAT to pass to the heirs at T's death would be calculated as follows:

Year	Beginning Principal	+ 5% Growth	- Annuity Payment	Remainder
1	$1,000,000	$1,050,000	$53,365	$996,635
2	$996,635	$1,046,466	$53,365	$993,101
3	$993,101	$1,042,756	$53,365	$989,391
4	$989,391	$1,038,819	$53,365	$985,495

The discount not only reduces the amount of the taxable gift, but also increases the amount left in the CLAT. The taxable gift decreases from $116,784 to $81,758 making the amount of gift tax payable $36,791 (.45 x $81,758). Meanwhile, the amount remaining in the CLAT to pass to the children increases from $886,923 to $985,495.[54] The overall effect is to reduce the effective gift tax rate on the transfer to about 3.73% ($36,791/$985,495).[55]

FAST-APPRECIATING ASSETS

The faster the CLAT assets appreciate, the greater the value left in the CLAT to pass to the heirs when the transferor dies. This means that a taxpayer can increase the amount of the tax-free transfer by selecting fast-appreciating assets to fund the CLAT.

53. Valuation discounts for minority or fractional interests are sometimes criticized because they typically effect only a temporary reduction in value. Eventually, the divided interests will be put back together and the full potential value of the assets will be realized by the family.

54. This difference is due entirely to the reduced amount of the annuity payments. It is the annual reductions appreciated at five percent to the date of the donor's death.

55. Note that if assets must be distributed in kind, the benefit of the discount would be lost. The same thirty percent discount would have to be applied to the assets so that a distribution of $53,368 worth of discounted assets would have the same value as a distribution of $76,235 of undiscounted assets, leaving the donor in the same position he would have been in if no discounts had been available.

EXAMPLE THREE

Assume the same facts as in Example Two, except that the trust assets now appreciate at twelve percent instead of five percent. Compare the amount remaining in the CLAT with the amount remaining in the previous example.

Year	Beginning Principal	+ 5% Growth	- Annuity Payment	Remainder
1	$1,000,000	$1,120,000	$53,365	$1,066,635
2	$1,066,635	$1,194,631	$53,365	$1,141,266
3	$1,141,266	$1,278,218	$53,365	$1,224,852
4	$1,224,852	$1,371,834	$53,365	$1,318,470

The effective gift tax rate is now only about 2.79% ($36,791/$1,318,470).

USING A GRANTOR TRUST

As explained above, a CLAT can be structured as a grantor trust causing the transferor to be taxed on the trust income. On the surface, at least, structuring the CLAT in this way would appear to improve its performance. The income tax payments made by the grantor are, in effect, tax-free transfers to the trust that permit its assets to grow at their pre-tax rate rather than at their after-tax rate.[56] This leaves more in the CLAT to pass to the remainder beneficiaries at the donor's death.

EXAMPLE FOUR

Assume the same facts as in Example Three, except that the donor pays the trust's income tax, that the trust's pre-tax total return is fifteen percent, and that the trust's effective tax rate is twenty percent. The effect of the tax payments by the grantor is

56. Suppose, for example, that the CLAT holds assets worth $100,000 and they produce $10,000 of taxable income. Suppose further that the average tax rate on the CLAT income is twenty percent. If the CLAT pays its own income tax, its assets will grow at eight percent per year. If the grantor pays the tax, however, the assets will grow at ten percent.

that the CLAT assets now grow at fifteen percent instead of twelve percent as shown below.

Year	Beginning Principal	+ 15% Growth	- Annuity Payment	Remainder
1	$1,000,000	$1,150,000	$7,000	$1,143,000
2	$1,143,000	$1,314,450	$8,400	$1,306,050
3	$1,306,050	$1,501,958	$10,080	$1,491,878
4	$1,491,878	$1,715,660	$12,096	$1,703,564

The effective gift tax rate is now only about 2.16% ($36,791/$1,703,564).

A non-grantor CLAT reduces the effective gift tax rate in the same way, however. Provided that the trust's taxable income does not exceed its annual payments to charity, the deduction that the CLAT receives for making these payments will reduce its taxable income to zero, permitting the CLAT assets to grow at their pre-tax rate of return just like the assets in a grantor CLAT. Although the transfer tax benefits are thus equalized, grantor trust status is still more favorable in most cases, though, because it generally produces better income tax consequences. As explained above, when a taxpayer makes a transfer to a CLAT, she receives an income tax deduction upfront but must pay tax each year on the CLAT's income.[57] Although these amounts are sometimes assumed to cancel each other out, the deduction will generally exceed the present value of the donor's future tax payments. The transferor receives the charitable deduction upfront while the income tax liability does not arise until the future, creating a timing advantage. Moreover, the upfront deduction can be applied against ordinary income taxed at rates of up to thirty-five percent, while the income taxed in later years may be capital gains or qualifying dividends taxed at only fifteen percent.[58]

57. I.R.C. § 170(f)(2)(B).

58. *See* Madsen, *supra* note 42, at 579.

The income tax advantage may be particularly important where the CLAT is used as a bet-to-die strategy because the donor will receive an income tax deduction for the present value of the lead interest. This is based on the assumption that the transferor will live to her actuarial life expectancy but make only a few income tax payments before dying. In the case of a grantor CLAT for a term of years, the early death of the donor provides no income tax advantage because any difference between the amount of the deduction and the value of the income tax payments made by the donor is recaptured as ordinary income.[59] Treasury regulations section 1.170A-6(d)(2) provides that if a grantor CLAT ceases to be a grantor trust before the end of its stated term (e.g., because the grantor dies), the transferor has taxable income as of that date equal to the amount of the income tax charitable deduction taken, minus the amount that would have been allowed as a deduction if the term of the charity's annuity interest had been the length of time the lead interest actually lasted.[60] In the case of a life CLAT, however, it would be impossible for the transferor to die before the end of the stated term because, by definition, the trust lasts until the transferor's death. Thus, although there appear to be no cases or rulings directly on point, a plausible argument could be made that there should be no recapture at the death of the transferor. If so, the taxpayer in our examples would receive an income tax deduction valued on the assumption that charity would receive twenty-one payments while paying tax on only four.

BACK-LOADING

Up to this point, we have assumed that annuity payments were the same each year. If payments can be back-loaded so that they start small and increase over the term of the annuity, it would substantially improve the performance of a bet-to-die

59. I.R.C. § 170(f)(2)(B); Treas. Reg. § 1.170A-6(c)(4) (2005).
60. Treas. Reg. § 1.170A-6(d)(2) (2005).

CLAT. Payments in the early years could be set much lower than they would be if level payments were made. Although the payments toward the end of the taxpayer's life expectancy would be correspondingly higher, the charity would never receive these later payments because the term of the trust would have ended before they were due.

The applicable Treasury regulations appear to permit back-loading of CLAT payments. The key provisions are as follows:

1. A "*guaranteed annuity interest*" qualifies for a charitable deduction.[61]
2. A guaranteed annuity interest is "*an arrangement under which a determinable amount is paid periodically, but not less than annually, for a specified term of years or for the life or lives of certain individuals, each of whom is alive on the date of the gift and can be ascertained at such date.*"[62]
3. An amount is determinable if "*the exact amount which must be paid under the conditions specified in the instrument can be ascertained as of the date of the gift.*"[63]

A back-loaded bet-to-die CLAT would appear to fall within this definition. Payments would be made periodically for the life of a specified individual who would be alive on the date the CLAT was created and whose identity could be ascertained as of that date. Moreover, the present value of any payment stream could be determined as of the time the gift was made so long as the amount of each payment was fixed. The payments would first be discounted back to the present value using the applicable I.R.C. section 7520 rate. Because the donor would only receive the payments if she was alive on the date they were due, the present value of each payment would then have to be multiplied by the probability that the transferor would survive long enough to receive the payment based on IRS mortality tables.

The IRS could make three arguments against back-loading.

---

61. Treas. Reg. §§ 25.2522(c)-3(c)(2)(vi)(a), 1.170A-6(c)(2)(i) (2005) (emphasis added).

62. *Id.* (emphasis added).

63. Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(a) (emphasis added).

One would be that the applicable regulation states that a determinable *amount* must be paid periodically, not determinable *amounts*, suggesting that payments cannot vary during the trust term.[64] This interpretation is inconsistent with I.R.S. Private Letter Ruling 9112009, however, which approved a CLAT having annuity payments that varied from one year to the next.[65] Further, back-loading is clearly permissible in a grantor retained annuity trust (GRAT).[66] GRAT payments can increase by twenty percent from one year to the next, suggesting that there is no general prohibition in the tax law on increasing payout annuities.[67] A second argument would be that a payment could be so small as to be de minimis, violating the periodic payment requirement.[68] This argument could be addressed by setting payments high enough to have some substance. Finally, actuaries commonly think of annuities as payment streams having equal payments each year or payments that change each year based on a formula.[69] This limited concept of an annuity does not appear to have been applied in the tax law, however.[70]

While back-loading appears to have considerable support, there may, nevertheless, be some risk. Given the powerful tax benefits explained below, the IRS could be expected to look for ways to prevent taxpayers from using it.

The first step in calculating the tax benefit of back-loading is

---

64. *Contra* I.R.S. Priv. Ltr. Rul. 91-12-009 (Mar. 22, 1991).

65. *Id.* (permitting payments to vary without even inquiring into the amount of the variation, suggesting that there is no limit on the amount of the annual increases assuming, perhaps, that none of the payments were so small that they lacked substance).

66. *See* Treas. Reg. § 25.2702-3(b)(1)(ii)(B) (2005).

67. *Id.*

68. Deborah V. Dunn & Katherine M. Cunningham, *Advantages to Back-Loading: An Analysis of Back-Loaded Annuity Payments from a CLAT or RPM Annuity Trust*, 28 TAX MGMT., EST., GIFTS & TR. J., 263, 263 (2004).

69. *Contra* I.R.S. Priv. Ltr. Rul. 91-12-009 (Mar. 22, 1991); Dunn & Cunningham, *supra* note 66, at 264-65.

70. *Cf.* Dunn & Cunningham, *supra* note 66, at 264-65 (suggesting that an annuity paying $10,000 per year for nine years with a very large final payment in year ten should qualify as a guaranteed annuity interest); *see also* Peter Melcher et al., *Splitting Assets Between Family and Charities at Death: Using CLATs to Improve the Opportunity Set*, 4 J. PRAC. EST. PLAN. 35, 41-42 (Feb./Mar. 2002).

to determine the amount of the taxable gift. Recall that payments in a life CLAT can be valued only until the time the CLAT assets would run out under the exhausting corpus rule. The value of the lead interest in such a CLAT would be the sum of the present values of all the payments that could be made from the CLAT up to that time.

EXAMPLE FIVE

Assume these facts:

- Taxpayer (T) transfers assets worth $1,000,000 to a CLAT;
- The applicable IRC section 7520 rate is five percent;
- T is seventy years old as of the date of the transfer;
- The CLAT assets grow at five percent per year.

If the payments are not back-loaded, and the value of the annuity stream is set equal to the value of the transferred assets, there would be a taxable gift of $183,445.97 and gift tax payable of $82,551. The operation of the CLAT would look like this:

Year	Beginning Principal	+ 5% Growth	- Annuity Payment	Remainder
1	$1,000,000	$1,050,000	$109,470	$940,530
2	$940,530	$987,557	$109,470	$877,987
3	$877,987	$921,886	$109,470	$812,416
4	$812,416	$853,037	$109,470	$743,567

Thus, the effective gift tax rate would be about 11.10%. Compare this result with the example below in which the annuity payments are back-loaded.

EXAMPLE SIX

Assume the same facts as in Example Five, except that the payments now increase by twenty percent each year.[71]

71. We have selected twenty percent increases because that is the maximum increase permitted for GRATs. Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

Appendix A shows how the value of the annuity stream from the CLAT would be calculated under the exhausting corpus rule.

Appendix A also shows that back-loading reduces the amount of the taxable gift from $183,445.97 to $38,138.29 ($1,000,000 - $961,861.71)[72] and reduces the gift tax payable to $17,158 (0.45 x $38,138.29). The amount left in the trust at the transferor's death would also be increased as shown in the next chart.

Year	Beginning Principal	+ 5% Growth	- Annuity Payment	Remainder
1	$1,000,000	$1,050,000	$14,626	$1,035,374
2	$1,035,374	$1,087,143	$17,551	$1,069,591
3	$1,069,591	$1,123,071	$21,062	$1,102,009
4	$1,102,009	$1,157,110	$25,274	$1,131,836

The $1,131,836 that passes to the remaindermen in the back-loaded CLAT represents a large improvement over the $743,567 that passed to the remaindermen in the level payment scenario. When we put together the reduced taxable gift with this increased transfer to the remaindermen, the effective gift tax rate drops from 11.10 percent to only about 1.52 percent! If we added in the other enhancements, like discounted assets, the effective gift tax rate amount would be even less.

SELECTING A MEASURING LIFE OTHER THAN THAT OF THE DONOR

Although life CLATs ordinarily use the donor as the measuring life, the regulations historically permitted the trust term to be based on the life or lives of other individuals provided that each such individual was living on the date of the gift and could be ascertained as of that date.[73] This suggests that

72. The reason for the reduced taxable gift is that back-loading lengthens the period before the trust assets do not run out until year nineteen. In the level payment scenario, the assets run out in year thirteen.

73. Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(a) (2005).

even if the transferor could not take advantage of a CLAT as a bet-to-die strategy because he had a normal life expectancy, he could select another individual who did have a favorable actual life expectancy to be the measuring life.[74] Unfortunately for taxpayers, a special provision was added to I.R.C. section 7520 regulations in 2002 limiting the individuals who can be used as the measuring life.[75] The only permissible measuring lives for a CLAT are now the transferor, the transferor's spouse, or an individual who, with respect to all remainder beneficiaries, other than charities, is either a lineal ancestor or a spouse of a lineal ancestor of those beneficiaries.[76]

ADVANTAGES AND DISADVANTAGES OF USING CLATS

Probably the most important advantage of a CLAT as a bet-to-die strategy is that it qualifies for the one year/fifty-percent safe harbor in Treasury regulations section 25.7520-3(b)(3), discussed above.[77] Although private annuities would also qualify, SCINs would not.[78] Another advantage is that it can be structured as a grantor trust. As explained below, using a trust as the purchaser in a private annuity sale may be problematic. If the transferor desires to benefit both charity and family members, a CLAT may be the most favorable strategy to use. Provided that the total

74. *See id.*

75. Treas. Reg. § 20.2055-2(e)(2)(vi)(a) (2005).

76. *Id.* The inclusion of this limitation in the regulations was in response to the use of what was commonly referred to as a "Vulture CLAT" or "Ghoul CLAT." Estate planners pushed the use of an alternative measuring life to its logical extreme by seeking out people with the ideal life expectancy due. These individuals were often quite young (e.g., thirty years old), but had a life expectancy of perhaps three or four years. Because they had a greater than fifty percent chance of surviving for at least one year, the IRS valuation tables could be used. In some cases, these unfortunate individuals were even paid for their services. Although these CLATs were viewed as unethical by many estate planners, they were used often enough to prompt the IRS to take action. *See* Randall D. Van Dolsen, *New Regulations Sanction 'Accelerated' Charitable Lead Trusts*, 28 EST. PLAN. 162 (2001) (discussing CLAT measuring life regulations).

77. Treas. Reg. § 25.7520-3(b)(3).

78. I.R.C. § 7520(a) (providing that valuation tables generally must be used to determine the value of "*any annuity, any interest for life or a term of years, or any remainder or reversionary interest*"); Gen. Couns. Mem. 39305 (holding that because a SCIN does not fall into any of these categories, it can be valued by reference to the taxpayer's actual life expectancy, taking into account any relevant information).

return on the trust assets exceeds the I.R.C. section 7520 rate, CLATs can be a more tax-efficient method of splitting wealth between charity and heirs than outright gifts.[79]

There are also a number of disadvantages:

- Unlike a private annuity sale, it is not possible to completely eliminate the taxable gift on a transfer to a life CLAT because of Treasury regulation section 25.7520-3(b)(2)(i).[80] Back-loading can greatly reduce the amount of the taxable gift, however, as explained in Example Six.
- Some value must pass from the family to charity.[81] For some transferors, this may not be consistent with their objectives.
- The private foundation rules apply to a CLAT.[82]
- The class of persons that can be used as measuring lives is quite limited.[83] The transferor may have greater flexibility in the case of private annuities.[84]

PRIVATE ANNUITY SALE

In the context of estate planning, a private annuity sale is a transfer of property from a senior family member (S) to a junior family member (B) in exchange for a promise by B to make annuity payments to S for the rest of S's life.[85]

79. *See* Melcher et al., *supra* note 70, at 39-40.

80. Treas. Reg. § 25.7520-3(b)(2)(i).

81. Note that the closer the value of the charity's interest is to this minimum amount, the larger the taxable gift on the transfer (the amount of taxable gift is the value of property transferred to CLAT minus the present value of the interest passing to charity).

82. I.R.C. § 4947(a)(2) (Westlaw through 2006 legislation).

83. Treas. Reg. § 25.2522(c)-3(c)(2)(vi)(a).

84. There are no specific limitations on who may be used as a measuring life for a private annuity. This issue is discussed in more detail below in the section on enhancing the benefits of private annuities.

85. *See* Howard Zaritsky & Ronald Aucutt, *Structuring Estate Freezes: Analysis with Forms*, Warren, Gorham & Lamont, at ¶ 12.03 (on file with author) (discussing private annuity sales).

GIFT TAX CONSEQUENCES

Assuming that the present value of the annuity stream is equal to the value of the property transferred, there are no gift tax consequences.[86] If the value of the property transferred exceeds the present value of the annuity stream, however, such excess constitutes a gift from the seller to the buyer.[87]

ESTATE TAX CONSEQUENCES

If property is transferred for a *bona fide* life annuity equal in value to the property sold, there will be no estate tax consequences when the transferor dies.[88] If the transaction looks more like a transfer with a retained income or equity interest, however, I.R.C. section 2036(a)(1) may apply and cause the transferred property to be included in the transferor's estate at its full date of death value.[89] This can be a highly unfavorable result because it returns all post-transfer appreciation on the sale to the transferor's gross estate.[90]

Where private annuity sales have been treated as transfers with a retained life state, any of the following factors were present: (1) annuity formalities were not observed or the transaction otherwise lacked economic substance;[91] (2) the seller retained control over the transferred property;[92] (3) there was a tie-in between the income produced by the transferred assets and the amount of the annuity payments;[93] (4) the buyer did not

86. I.R.C. § 2512(b) (Westlaw through 2006 legislation).

87. Treas. Reg. § 1.1015-4(a) (2005).

88. The annuity interest terminates at death, and no adjusted taxable gift is included in the gross estate because there was no taxable gift at the time of the sale. I.R.C § 2512(b).

89. I.R.C. § 2036(a)(1).

90. One of the purposes of making the sale was to remove future appreciation in the transferred assets from the gross estate, and this purpose would be frustrated.

91. I.R.S. Priv. Ltr. Rul. 95-13-001 (Mar. 31, 1995).

92. LaFargue v. Comm'r, 73 T.C. 40, 52-58 (1979); Estate of Holland, 47 B.T.A. 807, 813-15 (1942); Rev. Rul. 76-491, 1976-2 C.B. 302.

93. Fidelity-Philadelphia Trust Co. v. Smith, 356 U.S. 274, 278-81 (1958); Greene v. U. S., 237 F.2d 848, 851-54 (7th Cir. 1956); Lazarus v. Comm'r, 58 T.C. 854, 863-73 (1972); Rev. Rul. 68-183, 1968-1 C.B. 308 (1968).

have significant assets other than the purchased property from which to make the annuity payments;[94] or (5) the buyer was not personally liable for making all annuity payments regardless of the income produced by the purchased assets.[95] This means that the parties must respect the form of the transaction; the seller must give up dominion over the property; the annuity must be structured so that payments have no relationship to expected income; the buyer must have significant assets in addition to the purchased property; and the buyer must be obliged to use these assets to make annuity payments if the income from the purchased property proves to be insufficient.[96]

INCOME TAX CONSEQUENCES

The income tax consequences of a sale for a private annuity are provided in Revenue Ruling 69-74[97] and are basically the same as if the transferor sold the property and took back an installment note.[98] The seller recognizes capital gain on the excess of the sale proceeds over the seller's basis in the property and has ordinary income for the portion of the payments that function as a substitute for interest.[99] Thus, to determine the income tax consequences when each annuity payment is received, it is necessary to apportion payments among (1) non-taxable return of basis; (2) capital gain; and (3) ordinary income.[100]

The first step in making this apportionment is to determine the expected return on the annuity contract. This is the amount of the annual payments multiplied by the life expectancy of the transferor. The percentage of each payment that is non-taxable

94. *LaFargue*, 73 T.C. at 56-58; Rev. Rul. 76-491, 1976-2 C.B. 302.

95. *Fidelity-Philadelphia Trust*, 356 U.S. at 279-81; Rev. Rul. 68-183, 1986-1 C.B. 308.

96. *Cf.* Zaritsky & Aucutt, *supra* note 85, at ¶ 12.03[4] (discussing when the IRS and the courts have viewed a purported private annuity as a gift with a retained life estate).

97. Rev. Rul. 69-74, 1969-1 C.B. 43.

98. *Id.*

99. *Id.*

100. *See id.*

is the basis in the property over expected return. The percentage that is capital gain is the present value of the annuity contract minus basis and divided by the expected return. The percentage that is ordinary income is the expected return minus the present value of the annuity and divided by the expected return.

EXAMPLE SEVEN

Assume the following fact pattern:

- F sells property worth $1,000,000 to D in exchange for a private annuity;
- The annual payments are $80,000 per year;
- F has a basis of $300,000 in the property;
- F has a life expectancy of twenty years.

The expected return on the contract is $1,600,000 (20 x $80,000). Thus, each payment is divided as follows:

- 18.75 percent (300,000/$1,600,000) is return of basis.
- 43.75 percent ($1,000,000 - $300,000)/$1,600,000 is capital gain.
- 37.5 percent ($1,600,000 - $1,000,000/$1,600,000 is ordinary income.

Applying these percentages produces the following characterization of each $80,000 annual payment:

- Return of basis. $15,000
- Capital gain. $35,000
- Ordinary Income. $30,000

If the seller dies before recovering her entire basis, the remaining amount can be deducted on her final income tax return.[101] The buyer's income tax basis after the death of the seller is limited to the amount actually paid for the property.[102] Finally, case law exists which states that if the buyer's obligation is secured, the entire gain is recognized at the time of the sale

101. I.R.C. § 72(b)(3)(A) (Westlaw through 2006 legislation).
102. Rev. Rul. 55-119, 1955-1 C.B. 352.

rather than being recognized only as payments are received.[103]

ECONOMIC BENEFIT

A private annuity sale by a person with a shorter-than-average life expectancy results in the seller receiving fewer payments than would be expected for a person of the seller's age. This causes the amount transferred out of the estate to exceed the present value of the annuity stream coming back into the estate and producing a gift tax-free transfer. This benefit is illustrated in the next example.

EXAMPLE EIGHT

Assume the following facts:

- Seller (S) transfers assets worth $1,000,000 to Buyer (B);
- S takes back the right to receive an annuity for the rest of S's life;
- Payments on the annuity are to be made annually at the end of each year;
- S is fifty-five years old;
- The applicable I.R.C. section 7520 rate is five percent;
- T lives for four years and one day after making the transfer.

The applicable annuity factor under these facts would be 13.1173,[104] making the required annuity payment $76,235 ($1,000,000/13.1173). If S dies four years after making the sale, he would transfer $1,000,000 out of his gross estate while taking back only $304,940 (4 x $76,235). To make a proper comparison between these two amounts, however, we should compare their future values as of the date of S's death. If we apply a five percent growth rate (the applicable I.R.C. section 7520 rate) to all assets, their date of death value would be $1,215,506, and the

103. Estate of Bell, 60 T.C. 469, 475-76 (1973).

104. *See* I.R.S., ACTUARIAL VALUE: BOOK ALEPH, Pub. No. 1457 *available at* http://www.irs.gov/pub/irs-pdf/p1457.pdf.

value of the annuity stream coming back into S's estate would be $328,582, producing a tax-free transfer of $886,924 ($1,215,506 - $328,582).[105]

POSSIBLE ENHANCEMENTS

If we assume that a thirty percent discount could be taken, the value of the transferred assets would be reduced to $700,000 for federal transfer tax purposes, making the annual annuity payments $53,365 ($700,000/13.1173). The sum of the payments back to S would then be $213,459 (4 x $53,365) and their future value as of S's date of death would be $230,010.[106] The discounted value of the transferred property as of this date would be $850,854,[107] but its potential value to the family after the restrictions giving rise to the discount were removed (e.g., the assets were taken out of the partnership) would be $1,215,506 ($850,854/0.7). Thus, the tax-free transfer would be $985,496 ($1,215,506 - $230,010). This is $98,572 more than in the previous example.

Transferring faster-appreciating assets would increase the amount of the tax-free transfer in much the same way as it would in a transfer to a CLAT.

EXAMPLE NINE

Assume the same facts as in Example Seven, except that the transferred assets appreciate at twelve percent instead of five percent. Assuming that the seller invested the annuity payments at the same five percent rate as in the previous

105. Using the § 7250 rate as the discount rate provides a fairly conservative estimate of the economic benefit produced. The higher the growth rate assumed, the more favorable the results. Note that it does not make sense to talk about the effective gift tax rate in the case of a private annuity as we did in analyzing CLATs because a properly structured private annuity produces no taxable gift. The benefit of a private annuity is that the excess of the value transferred out of the estate over the value of the property coming back into the estate avoids transfer tax.

106. We are again assuming that the I.R.C. § 7520 rate (five percent) is the proper discount rate for appreciating the value of the assets.

107. $700,000 appreciated for four years at five percent.

example, the date of death value of the annuity stream would be the same $328,582, but the date of death value of the transferred property would now be $1,575,519, increasing the tax-free transfer to $1,246,937.[108]

MORE FAVORABLE MEASURING LIFE

As explained above, only a limited group of persons can be the measuring life for a CLAT.[109] There are no comparable regulations for private annuities. Thus, it appears to be possible to shop for particularly favorable persons to serve as the measuring life. If a person other than the seller is used as the measuring life, and the seller dies before such person, the annuity continues, and its value should be included in the seller's gross estate.[110]

TRANSFER TO A TRUST

Any possible advantage of making a private annuity sale to a trust must be weighed against two important disadvantages. One is that it will be more difficult to reduce the amount of the taxable gift to zero. The IRS has taken the position that when property is sold to a trust with a limited fund available from which payments could be made, the annuity stream can be valued only until such time as the trust would be expected to run out of funds, assuming that the trust assets grew at the I.R.C. section 7520 rate.[111] In Revenue Ruling 77-454,[112] a taxpayer, age fifty-one, transferred $70,000 to a trust in exchange for the trust's promise to pay the taxpayer a life annuity.[113] Under the IRS actuarial tables then in use, the life annuity factor for a fifty-one-

108. If we assume that the seller invests the annuity payments received at twelve percent, the future value of payment stream as of the seller's date of death is $364,352, and the tax-free transfer is reduced to $1,211,167.

109. Treas. Reg. § 25.2522(c)-3(vi)(a).

110. *See* Zaritsky & Aucutt, *supra* note 85, at ¶ 12.03[5].

111. Treas. Reg. § 25.7520-3(b)(2).

112. Rev. Rul. 77-454, 1977-2 C.B. 351.

113. *Id.*

year-old male was 11.1308, making the annual payment necessary to avoid a taxable gift $6,288.86 ($70,000/11.1308), and the trust was set up to pay this amount.[114] The taxpayer reported no taxable gift on the transfer.[115] The IRS ruled, however, that the fund had to be valued for the shorter of life or the time the trust assets would run out, which was about eighteen years under the facts of the case.[116] This reduced the value of the annuity to $61,133, leaving a taxable gift of $8,867 ($70,000 - $61,133).[117]

Transferring assets to a trust also creates a greater risk that I.R.C. section 2036 will apply than a transfer to an individual.[118] An individual would be personally liable on the note and would have to use assets, other than income from the purchased property, to make payments if necessary. This would make it easier for the seller to avoid the argument that the annuity is a retained equity interest. Taxpayers may be able to avoid application of I.R.C. section 2036(a) on a sale to a trust, however, by "seeding" the trust or having the trust beneficiaries personally guarantee the annuity payments.[119]

BACK – LOADING PAYMENTS

Although there appear to be no specific limitations on back-loading a private annuity, the payment stream would have to qualify as an annuity under general tax principles.[120] The term "annuity" is not defined in the Internal Revenue Code, but it is generally understood to mean a sum of money paid periodically

114. *Id.*

115. *See id.*

116. Rev. Rul. 77-454, 1977-2 C.B. 351.

117. *Id.*

118. I.R.C. § 2036.

119. *See* Milford B. Hatcher & Edward M. Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX. 152 (March 2000); *see also* Robert S. Keebler & Peter J. Melcher, *Structuring IDGT Sales to Avoid Sections 2701, 2702 and 2036(a)*, 32 EST. PLAN. 19, 19 (Oct. 2005) (discussing this issue in the context of sales to a defective grantor trust for an installment note). The issues are much the same if the transferor takes back a private annuity.

120. *See* Dunn & Cunningham, *supra* note 68, at 263.

that is part interest and part return of capital.[121] The Tax Court has defined the term as follows:

> 'Annuity' is a term somewhat loosely used in financial and legal nomenclature and is perhaps incapable of exact definition. Generally speaking, it designates a right . . . to receive fixed, periodical payments, either for life or a number of years. Its determining characteristic is that the annuitant has an interest only in the payments themselves and not in any principal fund or source from which they may be derived.[122]

A back-loaded annuity should qualify under this definition, provided that none of the payments are so small as to be insignificant.[123] Although the payments received increase over the term of the annuity, their amounts are fixed from the beginning, and they are paid periodically for the transferor's life. If the transferor dies prematurely, he or she has no right to any further payments.[124]

If the transferor dies prematurely, back-loading a private annuity reduces the amount of the annuity payments and increases the tax-free transfer.

EXAMPLE TEN

Assume the same facts as in Example Four, except that the annuity payments are made pursuant to a private annuity rather than from a CLAT. The annual payments will be the same as those shown in Example Four. Thus, the payments will be reduced from $109,470 each year to $14,626, $17,551, $21,062 and $25,274 in the first four years, respectively. The future value of the assets transferred to the heirs would be $1,215,506 ($1,000,000 appreciated for four years at five percent). The date

121. Comm'r v. Meyer, 139 F.2d 256, 259 (6th Cir. 1943); Bodine v. Comm'r, 103 F.2d 982, 984-85 (3rd Cir. 1939).

122. George H. Thornley, 2 T.C. 220, 233 (1943), *rev'd on other issue* 147 F.2d 416, 420-21 (3d Cir. 1945) (quoting Commonwealth v. Beisel, 13 A.2d 419 (Pa. 1940)).

123. *See* Dunn & Cunningham, *supra* note 68, at 263-64.

124. *See* Zaritsky & Aucutt, *supra* note 85, at ¶ 12.03[6] (agreeing that private annuities can have an increasing payout feature and include a back-loaded private annuity form in their treatise providing for payments that increase by twenty percent each year), Form 28 (permitting the measuring life to be someone other than the transferor).

of death value of the amount returning to the seller in the level payment scenario would be $471,829, producing a tax-free transfer of $743,677 ($1,215,506 - $471,829). The date of death value of this amount in the back-loaded scenario would be only $83,670, producing a tax-free transfer of $1,131,836, which is $388,159 more than with level payments.

ADVANTAGES & DISADVANTAGES OF A PRIVATE ANNUITY SALE

ADVANTAGES

The most important advantages of using a private annuity as a bet-to-die strategy are: (1) it clearly qualifies for the I.R.C. section 7520 safe harbor; (2) it can be structured so there is no taxable gift;[125] (3) any measuring life appears to be permissible; and (4) there is no need to give anything to charity.

DISADVANTAGES

There are four key disadvantages. First, the buyer receives no income tax deduction for the ordinary income component of the annual payments, even though it has a function much the same as interest. Second, the buyer's basis in the purchased property is limited to the sum of the annuity payments actually paid. Third, the note should be unsecured to avoid possible estate inclusion under I.R.C. section 2036(a).[126] Fourth, if the buyers did not have substantial assets of their own before the sale, and the purchased property does not produce as high a total return as the parties expected, it may be difficult for the buyers to make the required payments.[127]

---

125. Assuming the sale is made to an individual and not to a trust. If the sale were made to a trust, the IRS would try to apply the exhausting corpus rule of Treasury regulation § 25.7520-3(b)(2).

126. This limits buyers to those the seller is sure he can trust.

127. *See* Zaritsky & Aucutt, *supra* note 85, at §12.03[5] (discussing the possibility that the IRS might also attempt to apply the original issue discount (OID) rules to a back-loaded private annuity and discussing the benefits of a back-loaded private annuity). Proposed regulations issued in 1995 refused to extend the exclusion from the OID rules for life annuities found in I.R.C. § 1275(a)(1)(B) to annuities with payments increasing at any time during the term of the contract. Prop. Treas. Reg. § 1.1275-1(d) (1995). Final regulations

CONCLUSION

Case law and Treasury regulations require the IRS to use standard actuarial tables to value most life annuity interests. This creates a golden opportunity for taxpayers with shorter-than-average life expectancies to use CLATs or private annuities to transfer tremendous amounts of wealth at a dramatically reduced transfer tax. The benefits may exceed those available from any other strategies for making large wealth transfers. It may be possible to enhance these savings by transferring fast-appreciating discountable assets, back-loading the annuity payments, and/or taking advantage of grantor trust status. Given the potential power of these strategies, the IRS can expect to see them used more frequently in the future. Provided that all formalities are observed, the transactions are carefully structured, and the taxpayers do not carry them to extremes, both strategies appear to work under the applicable case law and Treasury regulations, even in their more advanced forms. We should caution, however, that because of the tremendous potential for reducing tax revenue, the IRS could be expected to do everything it can to find ways to attack these strategies.

---

on this subject issued in 1997 took a different approach, however, and excluded only life annuities in which the life contingency was not "*real or significant.*" Treas. Reg. § 1.1275-1(j)(1) (1997) (emphasis added). The regulations go on to state that an annuity had a bona fide life contingency only if the contract has no terms or conditions that can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant. *Id.*

Appendix A: Example Six

Year	Beginning Value[i]	Growth[ii]	Payment[iii]	Ending Value[iv]	PV of Payment[v]
1	$1,000,000	$50,000	$14,626	$1,035,374	$13,928.67
2	$1,035,374	$51,769	$17,551	$1,069,591	$15,917.71
3	$1,069,591	$53,480	$21,062	$1,102,009	$18,191.06
4	$1,102,009	$55,100	$25,274	$1,131,836	$20,789.35
5	$1,131,836	$56,592	$30,329	$1,158,099	$23,758.99
6	$1,158,099	$57,905	$36,394	$1,179,609	$27,153.00
7	$1,179,609	$58,980	$43,673	$1,194,917	$31,032.01
8	$1,194,917	$59,746	$52,408	$1,202,254	$35,465.31
9	$1,202,254	$60,113	$62,890	$1,199,478	$40,532.06
10	$1,199,478	$59,974	$75,647	$1,183,984	$46,322.75
11	$1,183,984	$59,199	$90,561	$1,152,622	$52,940.81

i. This column shows the value of the trust assets at the beginning of each year.

ii. The trust assets are assumed to grow at the applicable I.R.C. § 7520 rate of five percent.

iii. The beginning payment is the amount necessary to set the value of the annuity payment stream equal to the value of the property transferred to the CLAT, without taking into account the exhausting corpus rule. The payments then increase by twenty percent from one year to the next.

iv. This is the beginning value plus growth minus the annual payment.

v. This column shows the amount of each payment discounted back to present value at the I.R.C. § 7520 rate of five percent.

12	$1,152,622	$57,631	$108,673	$1,101,580	$60,504.41
13	$1,101,580	$55,079	$130,408	$1,026,252	$69,148.63
14	$1,026,252	$51,313	$156,489	$921,075	$79,027.85
15	$921,075	$46,054	$187,787	$779,341	$90,318.47
16	$779,341	$38,967	$225,345	$592,964	$103,222.14
17	$592,964	$29,648	$270,414	$352,198	$117,969.27
18	$352,198	$17,610	$324,496	$45,312	$134,823.22
19	$45,312	$2,266	$47,578	$0	$18,816.00
Total PV of Payment Stream	$961,861.71				