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Private Annuities

DEFERRAL OF GAIN ELIMINATED IN SALES OF APPRECIATED PROPERTY FOR A PRIVATE ANNUITY

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New Proposed Regulations would impose a higher capital gains tax on the acquisition of an annuity in exchange for appreciated assets, but the Regs. do not render these often-useful tools irrelevant to practical estate planning.

On 10/18/06, the Treasury Department and the IRS proposed Regulations under Section 72 (taxation of annuities and certain proceeds of endowment and life insurance contracts) and Section 1001 (determination of amount of and recognition of gain or loss). [FN1] These Regulations would dramatically change the income tax treatment of an exchange of property for a private or commercial annuity contract, by eliminating the deferral of income tax on such exchanges, and would require current realization of the fair market value ('FMV ') of the annuity in the year of the exchange. This article examines these Proposed Regulations, their effective date, their impact on typical estate planning transactions, and their suspect validity.

Background

In 1969, the IRS ruled that any gain realized on an exchange of appreciated property for an unsecured private annuity was recognized only over the transferor's actuarial life expectancy. The taxpayer in Rev. Rul. 69-74 [FN2] was a father who transferred a capital asset having an adjusted basis of $20,000 and an FMV of $60,000 to his son, in exchange for the son's unsecured legally enforceable promise to pay the father a lifetime annuity of $7,200 per year, in equal monthly installments of $600. In that Ruling, the IRS concluded that:

1 The father realized capital gain based on the difference between the father's basis in the property and the present value of the annuity;

2 The gain was reported ratably over the father's life expectancy;

3 The investment in the contract for purposes of computing the exclusion ratio was the father's basis in the property transferred;

4 The excess of the FMV of the property transferred over the present value of the annuity was a gift from the father to the son; and

5 The prorated capital gain reported annually was derived from the portion of each annuity payment that was not excludable.

Rev. Rul. 69-74 was issued in response to the decision of the Board of Tax Appeals (now the U.S. Tax Court) in Lloyd, [FN3] in which the taxpayer, J. Darsie Lloyd, sold appreciated property to his son, the comedian Harold Lloyd, for an unsecured annuity contract. The taxpayer

transferred shares of the stock of the Harold Lloyd Corporation to his son, in exchange for the son's promise to pay the taxpayer an annuity. The son promised to pay his father $100,000 per year, in equal quarterly installments, for so long as they both were alive, and thereafter the son's estate would pay the taxpayer $50,000 per year, also in equal quarterly installments, for the remainder of the taxpayer's life. The present value of the annuity promise was $850,434 and the taxpayer's adjusted basis in the stock was $122,567.68.

The taxpayer in Lloyd reported the gain on the sale under the open-transaction doctrine set forth in the Supreme Court's 1931 opinion in Burnet v. Logan. [FN4] In that case, the Supreme Court stated that, when the consideration received in an exchange of property assets had no ascertainable FMV, the transaction was not closed and gain should be realized only after recovery of basis. The taxpayer in Lloyd argued that, as the annuity payments in the year of sale were less than the taxpayer's adjusted basis, no gain should be recognized in that year.

The IRS, on the other hand, argued that the annuity contract had an ascertainable value, and that the taxpayer must recognize in the year of sale the difference between his adjusted basis in the stock and the ascertainable FMV of the annuity contract.

The Board of Tax Appeals in Lloyd held that the annuity contract had no ascertainable FMV, because of the uncertainty of payment from the son. Therefore, it stated, the taxpayer was not required to recognize the entire gain in the year of sale; rather, the taxpayer would recognize gain only when the annuity payments exceeded the property's basis. The court stated:

> The fair cost of an annuity based upon experience tables giving life expectancies can be determined by actuaries. A similar method would have to be used in order to estimate the present value of an annuity to the annuitant. But here a new element enters the computation, the uncertainty as to whether or not the one agreeing to make payments will be able to make them as agreed when the time for payment actually arrives. This difficulty might not be so great in the case of a sound insurance company regularly engaged in granting annuities or, perhaps, in the case of a bank. Cf. Guaranty Trust Co. of New York, Executor, 15 B.T.A. 20. Laws have been enacted to safeguard investors of such institutions. But that kind of an annuity is not involved in this case. Harold C. Lloyd was an individual. He was wealthy in 1930 but he was not engaged in the business of granting annuities, and his investments were not subject to restrictions and supervision as are those of insurance companies and banks. The evidence shows that the contract of April 16, 1930, whereby Harold C. Lloyd promised and agreed to make future payments to his father, the petitioner, had no fair market value within the meaning of section 111(c) when received by the petitioner on April 16, 1930. Cf. Helvering v. Louis, 77 Fed.(2d) 386, reversing 29 B.T.A. 1200; Commissioner v. Newbury, 80 Fed.(2d) 631. The Commissioner erred in including any gain from the transaction in the petitioner's income for 1930. [FN5]

Rev. Rul. 69-74 was thus an attempt to create a compromise between the immediate recognition sought by the IRS in Lloyd, and the open transaction approach adopted by the Board of Tax Appeals in that case. The Ruling requires that the taxpayer recover his or her adjusted basis ratably over the taxpayer's actuarial life expectancy, and that gain be reported annually based on the difference between the amounts received in that year and the taxpayer's allocated adjusted basis.

Why a change?

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The IRS, in its news release that accompanied announcement of the new Proposed Regulations and in the preamble to the Proposed Regulations, gives four reasons for a change in the government's position. [FN6] First, the IRS notes that the position in Rev. Rul. 69-74 creates a rule for the taxation of transfers of property made in exchange for an unsecured private annuity which is different from the rule for exchanges of property for commercial annuities and other kinds of property.

Second, the IRS notes that Rev. Rul. 69-74 was based in part on the assumption that the value of a private annuity contract could not be determined for federal income tax purposes. The IRS stated that this assumption was no longer correct, citing the comprehensive actuarial tables promulgated regularly under Section 7520.

Third, the IRS stated that Rev. Rul. 69-74 was based on the open-transaction doctrine of Burnet v. Logan. In the Regulations just proposed, the IRS stated that this doctrine has been eroded in recent years. The IRS cites no authority for this proposition, but it is consistent with similar statements in Reg. 1.1001-1(a) , that have been quoted and relied upon by several federal courts, and repudiated by none. [FN7]

Fourth, the IRS stated that it had learned that Rev. Rul. 69-74 has been relied upon inappropriately in a number of transactions that are designed to avoid U.S. income tax. The IRS does not specify the transactions, other than to say that they involve:

> private annuity contracts issued by family members or by business entities that are owned, directly or indirectly, by the annuitants themselves or by their family members. Many of these transactions involve a variety of mechanisms to secure the payment of amounts due under the annuity contracts. [FN8]

The Regulations do not explain why the IRS did not seek merely to curtail these abuses, rather than change the tax treatment of a broad spectrum of tax-benign transactions.

Income taxation of non-charitable annuities under the Proposed Regs.

The Proposed Regulations are relatively simple. They state that, if an annuity contract is received in exchange for property (other than money), three results occur:

> 1 The amount realized attributable to the annuity contract is its FMV (determined under Section 7520) at the time of the exchange;
>
> 2 The entire amount of the gain or loss, if any, is recognized at the time of the exchange, regardless of the taxpayer's method of accounting; [FN9] and
>
> 3 For purposes of determining the initial investment in the annuity contract under Section 72(c)(1) (the amount that determines the taxation of future payments from the annuity contract), the aggregate amount of premiums or other consideration paid for the annuity contract equals the amount realized attributable to the annuity contract (the FMV of the annuity contract). [FN10]

Consequently, if an unsecured private annuity promise or a commercial annuity contract is received by the transferor in exchange for property other than cash, the entire amount of the seller's realized gain or loss (if any) must be recognized at the time of the exchange, rather than recognized ratably over the seller's life expectancy. This rule will apply regardless of the method of accounting used by the taxpayer, and regardless of whether the annuity is created in the exchange or is a pre-existing contract.

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The Proposed Regulations do not distinguish between secured and unsecured annuity contracts, or between annuity contracts issued by an insurance company and those issued by a taxpayer who is not an insurance company. The same set of rules will apply to leave the transferor and transferee in the same position before tax, as if the transferor had sold the property for cash and used the proceeds to buy the annuity contract. [FN11]

The same rules would apply whether the exchange produces a gain or loss. The preamble notes, though, that this does not prevent the application of other provisions, such as Section 267, to limit deductible losses in the case of some exchanges. [FN12]

Significantly, the Proposed Regulations do not alter the existing rules governing tax-free exchanges of annuity contracts under Section 1035. They address only taxable exchanges of other property for an annuity contract. Accordingly, taxpayers may defer recognition of gain on an exchange of a contract of life insurance, an endowment contract, or a commercial annuity contract for a commercial annuity contract. [FN13]

Charitable gift annuities

The Proposed Regulations would not change the taxation of charitable gift annuities. [FN14] Rather, they would leave this class of annuities subject to the deferral rules of Reg. 1.1011-2 , which governs the tax treatment of an exchange of property that constitutes a bargain sale to a charitable organization (including an exchange of property for a charitable gift annuity).

Example 8 in Reg. 1.1011-2(c) states that any gain on an exchange of appreciated property for a charitable gift annuity is recognized and reported ratably over the seller's lifetime, rather than entirely in the year of the exchange. The new Proposed Regulations do not change this rule, but the IRS did request comments as to whether a change should be made in the future to conform the tax treatment of charitable gift annuities to the treatment proposed for non-charitable annuities.

Effective date

The Proposed Regulations generally apply to exchanges of property for an annuity contract after 10/18/06 (the publication date of the Proposed Regulations). The new Regulations would not apply to amounts received after 10/18/06 under annuity contracts that were received in exchange for property before that date.

The effective date is delayed for six months (until 4/18/07) for transactions that meet three requirements:

1 The issuer of the annuity contract must be an individual, rather than a corporation, partnership, trust, or other legal entity;

2 The obligations under the annuity contract cannot be secured, either directly or indirectly; and

3 The property transferred in the exchange cannot be sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange. [FN15]

Rev. Rul. 69-74 would be declared obsolete contemporaneously with the effective date of the new Regulations. Thus, the obsolescence would be effective 4/18/07 or 10/18/06, depending on which of the effective date rules applied to the exchange.

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Scope of the new rules

The new rules will significantly undermine the utility of traditional private annuity sales, by requiring that all gain in the asset be recognized on the date of the exchange, to the extent of the actuarial FMV of the annuity contract. Obviously, this is relevant only with respect to the exchange of substantially appreciated assets for an annuity. Exchanges of assets with little or no appreciation will generate very little taxable gain and so remain useful estate planning devices, and purchases of a private annuity for cash will generate no taxable gain and are expressly excluded from the operation of the Proposed Regulations.

The transferor of substantially appreciated assets will, therefore, want to minimize the value of the annuity promise for income tax purposes. The Regulations state that the promise is to be valued under the Regulations promulgated pursuant to Section 7520. This raises a question, though, about the proper valuation of a private annuity that is, by its terms, non-assignable.

Lottery cases. Several courts have recently reviewed the proper estate tax valuation of a right to a non-assignable lottery annuity, and the results are decidedly split. The issue first arose in Estate of Shackleford, [FN16] where the decedent bought a $1 California lottery ticket and won over $10 million, to be paid in 20 equal annual payments of $508,000. Under California law, a lottery prize was not assignable, but it could be paid to the estate of a deceased winner or to a person designated by court order.

The decedent died after receiving only a few payments, and attempted to bequeath his interest to his brother. On his estate tax return, his executor valued the remaining 17 payments at $4,023,903. The executor thereafter thought better of things, and filed an amended return and a refund claim, valuing the remaining lottery payments at zero.

The IRS contended that the right to the lottery payments should be valued like a private annuity for a term-of-years, under the applicable IRS actuarial tables. The estate argued that the payments were akin to a commercial annuity and that, therefore, the valuation is not based on actuarial computations under IRS Regulations, but rather what is charged for comparable annuities sold to the public.

The U.S. District Court noted that, despite the statutory rule to the contrary, at least ten California lottery prize winners had attempted to transfer their awards, and the prices at which those transfers occurred were substantially discounted to reflect the legal questions. The district court concluded that the actuarial tables did not reasonably approximate the FMV of the lottery payments because California's statutory anti-assignment restriction reduced the FMV. The court valued the annuity at $2,012,500, looking at prevailing California bond discount rates, and factoring in lack of marketability.

The Ninth Circuit affirmed, recognizing that Section 7520 requires the valuation of non-commercial annuities (such as lottery payments) actuarially, under the IRS tables, but that the Regulations allow departure from the tables where the tables do not produce a value that reasonably approximates the FMV. [FN17] The IRS argued unsuccessfully that the Section 7520 Regulations were supposed to establish a bright-line test for valuation of annuities, but the court disagreed, noting that the IRS had often sought to ignore the actuarial tables when the IRS was the disadvantaged party. [FN18]

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The results were more mixed in Estate of Gribauskas, [FN19] in which the decedent and his wife won a $15,807,306 million Lotto prize, to be paid in 20 annual, non-assignable installments. In his divorce, the decedent received a right to one-half of each payment. The decedent died when 18 payments were outstanding, and the payments were continued to his estate. The personal representative of the decedent's estate valued the Lotto rights at $2,603,661, using the rules of Section 2031 for valuing an unsecured debt. The IRS valued the payments under Section 7520, disregarding the non-assignability.

The Tax Court held that the Lotto payments must be valued under Section 7520, because they were a series of fixed payments, not tied to any specific asset or subject to any market fluctuation. The court refused to follow Shackleford, stating that the district court's analysis (which had not yet then been affirmed) would undercut the legislative purpose of Section 7520, to produce standardized actuarial valuation. The Tax Court stated that Reg. 20.7520-3(b) , which provides exceptions to the general application of Section 7520, did not apply where there was no substantial risk that payments would not be made.

The Second Circuit reversed, following the Ninth Circuit's analysis in Shackleford, because Section 7520 would produce an obviously erroneous result. [FN20]

The Tax Court in Estate of Cook [FN21] held that the lottery winnings must be valued under the actuarial tables, rather than under general valuation principles, despite the fact that the right to receive the lottery payments was held in a limited partnership in which the decedent did not own a controlling interest. The court followed its analysis in Gribauskas, and held that the use of the tables did not produce a result so unrealistic and unreasonable that the tables would be inapplicable.

The Fifth Circuit, in a split opinion, affirmed the Tax Court in Cook, rejecting the analyses of the Second and Ninth Circuits. The Fifth Circuit stated that the lottery payments fell within the general meaning of 'annuity,' and that, consequently, they must be valued according to the actuarial tables under Section 7520. According to the court, the tables could be ignored only if the facts disproved the assumptions that underlie the tables. The court ruled that the result produced by the valuation tables is not unreasonable because the factor accounting for the disparity between the expert and the table valuation--i.e., a marketability discount--is not properly applied to the lottery prize. The non-marketability of a private annuity is an assumption underlying the annuity tables. [FN22]

Since then, two more district courts have reviewed this situation, and their decisions are equally divided. The District Court for Massachusetts held, in Estate of Donovan, [FN23] that an unassignable right to receive payments under the Massachusetts lottery was valued strictly under Section 7520, without regard to marketability, while the District Court for New Hampshire reached the contrary position in Estate of Davis. [FN24]

This issue may be important in planning and drafting a private annuity under the Proposed Regulations. If the IRS is ultimately forced to discount the value of an annuity interest for lack of marketability, a clause rendering the annuity interest non-assignable and non-transferable may cause the value of the annuity interest to be reduced, thereby reducing the gain realized and recognized by the seller. Non-assignability clauses should, therefore, be included in a private annuity agreement that will be taxed under these new Regulations. Presumably, however, taxpayers will be bound by such reduced values for gift tax purposes.

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Installment method. The Proposed Regulations do not make the installment method available for private annuities, but Treasury has requested comments on whether there are any circumstances in which the installment method should be made available. Even though the Proposed Regulations expressly do not make the installment method available for private annuities, it should nevertheless be relatively easy to structure an annuity contract to fall outside the Proposed Regulations and be eligible for deferral of tax on gains under the installment reporting method.

Prop. Reg. 1.1001-1(j)(1) excludes from its application 'an annuity contract that is ... a debt instrument subject to sections 1271 through 1275.' An annuity contract will be a debt instrument subject to Sections 1271 through 1275 unless Section 72 applies to the contract and the contract depends (in whole or in substantial part) on the life expectancy of one or more individuals (the 'life annuity exception'). [FN25] Reg. 1.1275-1(j) provides rules that limit the life annuity exception to cases where the life contingency is 'real and significant.' [FN26] Reg. 1.1275-1(j)(2) states that an annuity contract depends on the life expectancy of an individual only if the contract provides for distributions at least annually, [FN27] and the contract does not contain any terms or provisions that can significantly reduce the probability that total distributions will increase commensurately with the longevity of the annuitant (or annuitants). [FN28]

Reg. 1.1275-1(j) then provides several examples of contractual provisions which significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant. For annuities entered into for estate tax planning purposes, the most relevant such contractual provision is a 'maximum payout provision.' [FN29]

The rules define a maximum payout provision as 'a contractual provision that provides that no distributions under the contract may be made after some date (the termination date), even if the terminating death has not yet occurred. ' [FN30] Hence, a sale for a self-canceling installment obligation ('SCIN '), that obliges the transferee to pay a fixed amount annually (or more often) for the shorter of a term of years or the transferor's lifetime is a contract with a maximum payout provision. [FN31] The Regulations provide an exception if the period of time from the annuity starting date to the termination date is at least twice as long as the period of time from the annuity starting date to the expected date of the terminating death, determined as of the annuity starting date. [FN32] Accordingly, any contract that obligates one party to pay a fixed sum for the shorter of a term of years or the annuitant's life will be treated as an annuity with a maximum payout provision, and thus a debt instrument not subject the new Regulations, unless the annuity termination date is beyond double the annuitant's life expectancy.

For most taxpayers, it should be relatively easy to convert a private annuity into a debt instrument by providing a maximum payout provision that is within double the taxpayer's life expectancy. Such a shorter of term or life annuity will not be subject to the Proposed Regulations and will presumably be eligible for the installment method. Additionally, this exception should ensure that all transactions structured as self-canceling installment notes are not subject to the Proposed Regulations.

Moreover, the Proposed Regulations do not alter the estate or gift tax treatment of a sale of property for a private annuity. The value of the unpaid portion of a private annuity obligation is generally excluded from the annuitant's gross estate. [FN33] Furthermore, as long as the actuarial FMV of the annuity obligation is at least equal to the value of the transferred assets, there is

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no taxable gift on the creation of a private annuity. [FN34]

Basis considerations. It seems logical that the Proposed Regulations would be accompanied by a change in the rules by which the obligor's income tax basis is determined in a private annuity transaction. Before these Regulations were proposed, the obligor's adjusted basis in the property purchased for a private annuity depended upon when and for what purpose basis was being computed. Generally, the rules for determining basis were:

1 The obligor's basis in the annuity property during the annuitant's lifetime, for purposes of depreciation and determining the gain recognized on a sale or exchange of the annuity property, was the amount of consideration paid for the property (assuming that there was no gift feature); this was usually the present value of the annuity promise on the date of the agreement.

2 The obligor's basis in the annuity property for purposes of determining the loss recognized on a sale or exchange of the annuity property during the annuitant's lifetime was equal to the amount of the payments actually made, less any allowable depreciation.

3 A sale by the obligor during the annuitant's lifetime at a sale price that exceeded the amounts actually paid by the obligor to that date, but that was less than the present value of the promised annuity, resulted in neither a gain nor a loss. Subsequent payments could cause the obligor to recognize a loss on such a sale, if the total of actual annuity payments exceeded the sale price.

4 The obligor's basis after the annuitant's death was the total of all the annuity payments made by the obligor, less any depreciation deductions allowable with respect to the annuity property. [FN35]

One must hope that the Prop. Regs.' requirement that the annuitant recognize the gain on the sale of property for a private annuity in the year of the sale will be coupled with a grant to the obligor of a basis in the purchased assets equal to the FMV of the annuity obligation on the date of sale, regardless of when the annuitant dies.

Are the Prop. Regs. valid? [FN36]

Attacking the validity of Regulations is usually an act of desperation, but victories in such attacks are not without precedent. The Supreme Court stated in Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., [FN37] that the opinion of an agency must be given great deference. As the Court recently stated:

> [A]mbiguities in statutes within an agency's jurisdiction to administer are delegations of authority to the agency to fill the statutory gap in reasonable fashion. Filling these gaps. . . involves difficult policy choices that agencies are better equipped to make than courts. . . . If a statute is ambiguous, and if the implementing agency's construction is reasonable, Chevron requires a federal court to accept the agency's construction of the statute, even if the agency's reading differs from what the court believes is the best statutory interpretation. [FN38]

The Court did modify the Chevron standard somewhat in Mead Corp., [FN39] stating that deference is warranted when Regulations or other agency interpretations reflect the exercise of congressionally delegated authority to bind regulated parties with the force and effect of law. It seems clear that the Treasury has the authority to bind taxpayers with the force and effect of law, and that the Regs. will be entitled to the greatest deference from the courts.

There are two types of Regulations: legislative and interpretative. Legislative Regulations

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are issued pursuant to a specific delegation from Congress to the Secretary. Interpretative Regulations are issued under the general authority vested in the Secretary under Section 7805(a), and are valid unless they are unreasonable. [FN40] Interpretative Regulations are generally valid, as long as they implement the congressional mandate in a reasonable manner, even if it is not the manner in which the court would have itself selected. [FN41] The Regulations under Sections 72 and 1001 appear to be interpretative Regulations.

The Proposed Regulations seem to be a reasonable interpretation of Sections 72 and 1001, neither of which specifically provides for deferred reporting of the gain on an exchange of appreciated assets for an annuity obligation. The IRS may be criticized for providing different treatment for charitable gift annuities without legislative authority, but invalidating this portion of the Regulations would not necessarily restore favorable treatment for non-charitable annuities. Furthermore, concern about this distinction may be why the IRS has requested comments on the propriety of such separate treatment of charitable annuities.

Conclusion

Private and commercial annuities have traditionally been useful means of providing a client with increased income, while removing assets from the client's gross estate. The Proposed Regulations impose a significantly higher capital gains tax on the acquisition of an annuity in exchange for substantially appreciated assets, and practitioners will need to recalculate the relative estate tax savings and income tax costs of using annuities in an estate plan, but they have not rendered these often-useful tools irrelevant to practical estate planning.

Under the Prop. Regs., the seller's entire gain or loss must be recognized at the time of the exchange, rather than ratably over the seller's life expectancy.

Significantly, the Proposed Regulations do not alter the existing rules governing tax-free exchanges of annuity contracts under Section 1035.

The Proposed Regulations would not change the taxation of charitable gift annuities.

The new rules will significantly undermine the utility of traditional private annuity sales.

The Proposed Regulations do not alter the estate or gift tax treatment of a sale of property for a private annuity.

PRACTICE NOTES

The Proposed Regulations would dramatically change the income tax treatment of an exchange of property for a private or commercial annuity contract, by eliminating the deferral of income tax on such exchanges, and would require current realization of the FMV of the annuity in the year of the exchange.

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[FN1]. REG-141901-05, 71 Fed. Reg. 61441 (10/18/06). See also discussion in Steve Leimberg's Estate Planning Newsletter #1036 (10/17/06) at www.leimbergservices.com. On private annuities generally, see Henkel, Estate Planning and Wealth Preservation: Strategies and Solutions, ch. 13 (Warren, Gorham & Lamont); Streng and Davis, Retirement Planning: Tax and Financial Strategies ¶16.03 (Warren, Gorham & Lamont, 2d ed.); Zaritsky, Tax Planning for Family Wealth Transfers ¶12.05 (Warren, Gorham & Lamont 4th ed.); Zaritsky and Aucutt, Structuring Estate Freezes After Chapter 14 ¶12.03 (Warren, Gorham & Lamont 2d ed.). See also Leimberg and Hodges, 'The Income and Estate Planning Advantages of Private Annuities,' 33 ETPL 3 (Feb. 2006) ; and Leimberg and Hodges, 'Maximizing the Planning Opportunities of Private Annuities,' 33 ETPL 13 (Mar. 2006) . The following are also excellent references: Zollars, 'Take That Private Annuities! New IRS Proposed Regulations,' PodCast at Leimberg Information Services, Inc. ('LISI') AudioServices; and Buhl, 'Treasury Official Explains Proposed Rules for Private Annuities,' 2006 TNT 204-11 (10/23/06).

[FN2]. 1969-1 CB 43.

[FN3]. 33 BTA 903 (1936), nonacq., XV-2 CB 39 (1936), nonacq. withdrawn and acq., 1950-2 CB 3.

[FN4]. 283 U.S. 404, 9 AFTR 1453 (S.Ct., 1931).

[FN5]. Lloyd, 33 BTA at 905.

[FN6]. IR-2006-161 (10/16/06); 71 Fed. Reg. 61441 (10/18/06).

[FN7]. See, e.g., Patton Testamentary Trust, 87 AFTR2d 2001-1587, 2001 WL 429809 (Ct. Fed. Cl., 2001), stating: 'The doctrine now applies only in 'rare and extraordinary cases,' and is generally rejected 'in favor of the best estimate of fair market value which the circumstances allow.' Rosenberg v. United States, 3 Cl.Ct. 432, 438 (1983) (citing Campbell v. United States, 228 Ct. Cl. 661, 670-71 (1981); Estate of Bird v. United States, 534 F.2d 1214, 1218 (6th Cir. 1976); McCormac v. United States, 191 Ct. Cl. 483 (1970); Denver & Rio Grande W. R.R. v. United States, 162 Ct. Cl. 1 (1963); Grill v. United States, 157 Ct. Cl. 804 (1962); Garvey, Inc. v. United States, 1 Cl. Ct. 108, 123 (1983)).' 2001 WL 429809 at *3. Also see Pree, 408 F.3d 855, 867, 95 AFTR2d 2005-2491 (CA-7, 2005); Bailey, 912 F.2d 44, 48, 66 AFTR2d 90-5473 (CA-2, 1990); Baumer, 580 F.2d 863, 885, 42 AFTR2d 78-5978 (CA-5, 1978); Weigl, 84 TC 1192, 1221 (1985); 212 Corp., 70 TC 788, 805, n.1 (1978); O'Leary, TCM 1986-212; Trigon Ins. Co., 215 F.Supp.2d 687, 710, 90 AFTR2d 2002-5891 (DC Va., 2002).

[FN8]. 71 Fed. Reg. at 61443. Private annuities are traditionally entered into among family

members, and secured annuities were already treated as closed transactions the gain on which was taxable in the year of the exchange. It seems odd, therefore, that the Treasury would highlight these two features as abuses justifying a change in the rules.

[FN9]. Prop. Reg. 1.1001-1(j)(1).

[FN10]. Prop. Reg. 1.72-6(e)(1). The preamble states: 'Thus, in situations where the fair market value of the property exchanged equals the fair market value of the annuity contract received, the investment in the annuity contract equals the fair market value of the property exchanged for the annuity contract.' The preamble also explains that this rule determining the investment in the annuity contract under Section 72(c)(1) is intended to ensure that none of the gain or loss on the exchange is duplicated or omitted by the application of Section 72 in the years after the exchange. The annuitant's investment in the contract would be reduced in subsequent years under Section 72(c)(1)(B) for amounts already received under the contract after the exchange, and excluded from gross income when received as a return of the annuitant's investment in the contract. 71 Fed. Reg. at 61443.

[FN11]. 71 Fed. Reg. at 61443. Security of any type, directly or indirectly, has traditionally been held to preclude income tax deferral. In Estate of Bell, 60 TC 469 (1973), acq. in part and nonacq. in part, 1974 WL 36039 (1/8/74), acq., AOD No. 1979-184 (8/15/79), spouses transferred stock in two closely held corporations to their children and their children's spouses in exchange for an annuity contract. The FMV of the stock substantially exceeded the value of the annuity contract. The stock transferred was placed in escrow to secure the promise of the transferees. As further security, the annuity agreement provided for a cognovit judgment against the transferees' in the event of default. Because of the secured nature of the annuity, the Tax Court held that (1) the difference between the value of the stock and the value of the annuity contract constituted a gift; (2) the difference between the adjusted basis of the stock and the value of the annuity contract constituted gain that was taxable in the year of the transfer (which was not before the court); and (3) the investment in the annuity contract equaled the present value of the annuity. Similarly, in 212 Corp., supra note 7, the Tax Court held that the entire amount of gain realized from the exchange of appreciated real property for an annuity contract was fully taxable in the year of the exchange because the annuity contract was secured by (1) an agreement that the annuity payments would be considered a charge against the rents from the property, (2) an agreement not to mortgage or sell the property without written consent of the transferors, and (3) the authorization of a confession of judgment against the transferee in the event of default.

[FN12]. 71 Fed. Reg. at 61443.

[FN13]. Section 1035(a). A commercial annuity contract is a contract with an insurance company which depends in part on the life expectancy of the insured, and which can be paid only in installments over the insured's life. Section 1035(b).

[FN14]. On charitable gift annuities generally, see Hill and Mancino, Taxation of Exempt Organizations, ¶26.03[7] (Warren, Gorham & Lamont); Colliton, Charitable Gifts, ¶8.02 (Warren, Gorham & Lamont); Henkel, supra note 1, at ch. 34; Zaritsky, Tax Planning for Family Wealth Transfers, supra note 1, at ¶5.08. See also Bird, 'The Charitable Giving Techniques Most Charities Overlook,' 16 Tax'n of Exempts 260 (May/June 2005); and Hester and Turner, 'Navigating the Transfer Tax Maze of Charitable Life Income Plans,' 32 ETPL 32 (May 2005) .

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[FN15]. The Proposed Regulations contain no mechanism to enforce this provision in the event of a subsequent disposition. The annuity contract either is taxable or non-taxable when entered into; if the annuity obligor subsequently disposes of the property acquired in the exchange, it would appear that the original exchange would become a taxable transaction. It is unclear whether the annuitant must then amend a previously-filed income tax return to report the additional gain. It is also unclear how the annuitant is to know that the obligor has sold or exchanged the property received in the exchange for the annuity. The obligor has no legal obligation to inform the annuitant.

[FN16]. 262 F.3d 1028, 88 AFTR2d 2001-5658 (CA-9, 2001), aff'g 84 AFTR2d 99-5902, 1999 WL 744121 (DC Cal., 1999). On these cases generally, see also Aghdami, 'The Morning After: Tax Planning for Lottery Winners, ' JTAXXXXX22890 90 J. Tax'n 228 (Apr. 1999); Gerzog, 'Actuarial Tables Versus Factually Based Estate Tax Valuation: Ithaca Trust Re-Visited,' 38 Real Prop., Prob. & Tr. J. 745 (Winter 2004); Grogan, 'Lucky for Life: A More Realistic and Reasonable Estate Tax Valuation for Nontransferable Lottery Winnings,' 79 Wash. L. Rev. 1153 (Nov. 2004); Kao, 'Valuing Future Lottery Winnings for Estate Tax Purposes: Estate of Shackleford v. United States' 52 Tax Law. 609 (Spring 1999); Hays and Krzanowski, 'When IRS Actuarial Tables Don't Apply in Valuing Interests,' 32 ETPL 21 (Feb. 2005) ; and commentaries in Steve Leimberg's Estate Planning Newsletters #s 924, 909, 614, 577, and 333 at www.leimbergservices.com.

[FN17]. Quoting from O'Reilly, 973 F.2d 1403, 1407, 70 AFTR2d 92-6211 (CA-8, 1992).

[FN18]. See, e.g., O'Reilly, supra note 17; Estate of Lion, 438 F.2d 56, 27 AFTR2d 71-1655 (CA-4, 1971); Froh, 100 TC 1 (1993), aff'd 46 F.3d 1141, 75 AFTR2d 95-808 (CA-9, 1995) (unpublished).

[FN19]. 116 TC 142 (2001), rev'd 342 F.3d 85, 92 AFTR2d 2003-5914 (CA-2, 2003). See commentaries by Katzenstein and Hood, 'Gribauskas, 2nd Cir. Reverses Tax Court Valuation Process,' Steve Leimberg's Estate Planning Newsletter #577 at www.leimbergservices.com.

[FN20]. Citing also Berzon, 534 F.2d 528, 532, 37 AFTR2d 76-1601 (CA-2, 1976); and O'Reilly, 973 F.2d at 1408.

[FN21]. 349 F.3d 850, 92 AFTR2d 2003-7027 (CA-5, 2003), aff'g TCM 2001-170.

[FN22]. Cook, 349 F.3d at 855.

[FN23]. 95 AFTR2d 2005-2131, 2005 WL 958403 (DC Mass., 2005).

[FN24]. 97 AFTR2d 2006-332, 2005 WL 3464384, 248 DTR K-5, 2005 TNT 250-8 (DC N.H., 12/19/05), order corrected on reconsideration, 97 AFTR2d 2006-824, 2006 WL 213761, 2006 TNT 22-9 (DC N.H., 1/27/06).

[FN25]. Section 1275(a)(1)(B)(i).

[FN26]. Reg. 1.1275-1(j)(1) .

[FN27]. Reg. 1.1275-1(j)(2)(i)(A) .

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[FN28]. Reg. 1.1275-1(j)(2)(i)(B) .

[FN29]. The other contractual provisions mentioned in the Section 1275 Regulations would not typically exist in an estate tax planning private annuity due to the risk of estate inclusion.

[FN30]. Reg. 1.1275-1(j)(6) .

[FN31]. On self-canceling installment notes generally, see Henkel, supra note 1, at ¶30.07; Westfall and Mair, Estate Planning Law and Taxation ¶10.04 (Warren, Gorham & Lamont, 4th ed); Zaritsky and Aucutt, Structuring Estate Freezes After Chapter 14, supra note 1, at ¶12.02[3]; Zaritsky, Tax Planning for Family Wealth Transfers, supra note 1, at ¶12.04. See also Banoff and Hartz, 'Sales of Property: Will Self-Canceling Installment Notes Make Private Annuities Obsolete?,' 59 Taxes 499 (1981); Banoff and Hartz, 'It's No Sin to SCIN! A Reply to Professor Blum on Self-Canceling Installment Notes,' 60 Taxes 187 (1982); Banoff and Hartz, 'New Tax Court Case Expands Opportunities for Self-Canceling Installment Notes,' JTAX06199233277 77 J. Tax'n 332 (June 1992); Blum, 'Self-Canceling Installment Notes--The New SCIN Game?,' 60 Taxes 183 (1982); Malin, 'Self-Canceling Installment Notes Maintain Estate Planning Usefulness,' 65 Prac. Tax Strategies 141-44 (Sept. 2000); Roszak, 'Installment Sales Terminating at Death Versus Private Annuities as Estate Planning Devices,' JTAXXX19832059 59 J. Tax'n 20 (1983); and Esterces, 'SCINs Are Still Useful Tools Despite Recent Decision,' 21 ETPL 12 (Jan./Feb. 1994) .

[FN32]. Reg. 1.1275-1(j)(6)(iii) . The expected date of the terminating death must be determined by reference to the applicable mortality table prescribed under Section 417(e)(3)(A)(ii)(I).

[FN33]. See Fidelity Philadelphia Trust Co. v. Smith, 356 U.S. 274, 1 AFTR2d 2151 (S.Ct., 1958); Helvering v. Estate of Rhodes, 117 F.2d 509, 26 AFTR 440 (CA-8, 1941); Estate of Zeitz, 34 TC 351 (1960); Estate of Milner, 6 TC 874 (1946); Estate of Bergan, 1 TC 543 (1943), acq., 1943 CB 2; Rev. Rul. 55-438, 1955-2 CB 601.

[FN34]. Rev. Rul. 55-119, 1955-1 CB 352; Reg. 25.2512-5 .

[FN35]. Rev. Rul. 55-119, supra note 34; Rev. Rul. 72-81, 1972-1 CB 98.

[FN36]. See Rapkin and Tempska, 'Private Annuity Proposed Reg--Did Treasury Go Too Far Too Fast?,' Steve Leimberg's Estate Planning Newsletter #1050 (11/15/06), at www.leimbergservices.com.

[FN37]. 467 U.S. 837 (S.Ct., 1984). See also the excellent article, Hickman, 'The Need for Mead: Rejecting Exceptionalism in Judicial Deference, ' 90 Minn. L. Rev. 1537 (June 2006).

[FN38]. National Cable & Telecommunications Ass'n v. Brand X Internet Services, 545 U.S. 967 (S.Ct., 2005).

[FN39]. 533 U.S. 218 (S.Ct., 2001).

[FN40]. Swallows Holding, Ltd., 126 TC 96, 129 (2006). That decision also noted that Section 7805(a): 'reflects a broad delegation of general authority from Congress to the Secretary to prescribe all needful rules and Regulations for the enforcement of the Internal Revenue Code. See United States v. Correll, 389 U.S. 299, 306-307, 88 S.Ct. 445, 19 L.Ed.2d 537 (1967). '

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Swallows Holding, Ltd., 126 TC at 129.

[FN41]. Nat'l Muffler Dealers Ass'n, Inc., 440 U.S. 472, 43 AFTR2d 79- 828 (S.Ct., 1979).

34 Est. Plan. 3, 2007 WL 196728 (W.G.&.L.)

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Estate Planning
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From Howard M. Zaritsky

PRACTICAL ETHICS WHEN REPRESENTING SPOUSES JOINTLY IN ESTATE PLANNING

Howard M. Zaritsky [FNa1]

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Estate planning attorneys usually represent both spouses in preparing their estate plan. It is a practical necessity in estate planning, despite the sometimes-serious conflicts of interest that may exist between the spouses. A recent disciplinary ruling in Texas demonstrates the risks inherent in this common practice. [FN1]

Background

In the Texas case, a member of the attorney's law firm prepared estate planning documents for a husband and wife, including reciprocal wills. The firm had represented the husband in other legal matters, as well.

The attorney later drafted a new will for the wife, replacing the husband as residuary beneficiary with the wife's mother. The attorney failed to obtain the prior consent of the husband before representing the wife in preparing the new will.

The Texas State Bar ruled that the actions of the attorney violated the conflict of interest rules with respect to former clients, which provide (in applicable part) that a lawyer cannot, without prior consent, represent a person in a matter adverse to the interests of a former client. The Texas Bar issued a public reprimand and ordered the attorney to pay $500 in attorney's fees.

Model Rules of Professional Conduct

An attorney who jointly represents a married couple in estate planning must be aware of several of the ABA Model Rules of Professional Conduct. Rule 1.6 (Confidentiality of Information) generally prohibits a lawyer from revealing information relating to representation of a client without the client's informed consent. [FN2]

Rule 1.7 (Conflicts of Interest; Current Clients) states that a lawyer may not represent a client 'if the representation involves a concurrent conflict of interest.' The rule defines a 'concurrent conflict of interest' as one in which either:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

Rule 1.7 permits a lawyer to represent a client who has a concurrent conflict of interest,

however, if the lawyer reasonably believes that he or she can provide 'competent and diligent representation to each affected client' and each affected client gives informed consent in writing. [FN3]

Rule 1.7 does not require that the interests of the spouses be identical, only that they not be directly adverse to each other and that there be no significant risk that representing one spouse will materially limit the lawyer's representation of the other spouse.

The American College of Trust and Estate Counsel ('ACTEC') commentaries on the Model Rules state expressly that this does not preclude a lawyer from representing a husband and wife whose testamentary dispositions differ, though it may be appropriate in such cases to interview each client individually. These commentaries state:

> In some instances the clients may actually be better served by such a representation, which can result in more economical and better coordinated estate plans prepared by counsel who has a better overall understanding of all of the relevant family and property considerations. The fact that the estate planning goals of the clients are not entirely consistent does not necessarily preclude the lawyer from representing them: Advising related clients who have somewhat differing goals may be consistent with their interests and the lawyer's traditional role as the lawyer for the 'family'. [FN4]

Rule 1.8(b) (Conflict of Interest: Current Clients: Specific Rules) states in applicable part, that a lawyer may not generally use information relating to representation of a client to the client's disadvantage, absent informed consent. This may arise when one spouse provides the lawyer with information that the other spouse could possibly use to the first spouse's disadvantage.

Rule 1.9 (Duties to Former Clients) generally imposes upon an attorney, even after termination of the lawyer-client relationship, continuing duties with respect to client confidentiality and the avoidance of conflicts of interest. Rule 1.9(a) provides that a lawyer who has formerly represented a client in a matter may not then represent another person in the same or a substantially related matter in which the latter person's interests are materially adverse to the interests of the former client, absent informed consent in writing from the former client.

Rule 1.9(b) extends a similar rule to a lawyer whose firm has previously represented the client in the same or a substantially related matter.

Rule 1.9(c) generally bars a lawyer from using information obtained by the lawyer or his or her firm in a former representation to the disadvantage of the client.

Practical estate planning

Obviously, not all married couples have inherent conflicts of interest. Many married couples wish to benefit the same persons, subject to the same restrictions and conditions, and to name the same or reciprocal fiduciaries. Indeed, this was the case initially for the couple involved in the Texas ruling.

Changed circumstances or wishes, however, can create substantial concurrent conflicts of interest, if one spouse changes his or her dispositions without the knowledge of the other. The error made by the lawyer in the Texas disciplinary case was not representing both spouses, but representing the wife in changing her estate plan in a manner materially adverse to the husband.

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[FN5]

A lawyer cannot normally practice estate planning without representing both spouses jointly. The lawyer should establish rules and practices to minimize ethical problems in such cases. These might include the following:

1 The lawyer should require that the prospective clients sign a written waiver of confidentiality as to each other, so that any information provided to the lawyer by either spouse must be revealed to the other spouse. The reluctance of a prospective client to sign such a waiver should alert the lawyer to the possible existence of an unwaivable conflict of interest. All information provided to the lawyer is still protected against disclosure to any third party.

2 The lawyer should give the prospective clients a statement that their interests may conflict, particularly where the spouses do not agree on the identity of their major beneficiaries or their fiduciaries. Both spouses should sign this statement, agreeing to allow the lawyer to use his or her best efforts and judgment to represent each of them, despite these possible conflicts.

3 The client's fee agreement should permit the lawyer to withdraw if the lawyer determines that there is a non-waivable conflict of interest, or if the clients do not agree to waive a perceived significant conflict of interest.

4 The lawyer should require that both spouses be present whenever either spouse changes his or her estate planning instrument.

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[FN1]. 69 Tex. Bar J. 904 (Oct. 2006).

[FN2]. See A. v. B., 158 N.J. 51, 726 A.2d 924 (1999) (a law firm that was jointly representing a husband and wife in estate planning could disclose to the wife the existence (but not the identity) of husband's child born out of wedlock).

[FN3]. The rule also requires that the representation neither be prohibited by law nor involve 'the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal.' These requirements, however, do not typically arise in an estate planning context.

[FN4]. ACTEC Commentaries on the Model Rules of Professional Conduct, comment on MRPC 1.7, 'General Nonadversary Character of Estates and Trusts Practice; Representation of Multiple Clients.' See also Cone v. Culverhouse, 687 So. 2d 888 (Fla. Dist. Ct. App., 1997). On the ACTEC Commentaries generally, see also Ross, 'Ethical Guidelines for the Estates and Trusts Lawyer: The ACTEC Commentaries on the Model Rules of Professional Conduct, ' Koren Estate and Personal Financial Planning Update (July, 2006); and Special Study Committee on Professional Responsibility, ABA Section of Real Property, Probate and Trust Law, 'Comments and Recommendations on the Lawyer's Duties in Representing Husband and Wife; Preparation of Wills and Trusts That Name Drafting Lawyer as Fiduciary,' 28 Real Prop. Prob. & Tr. J. 803 (Winter 1994).

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[FN5]. It is not clear whether the same problem would have arisen had the lawyer or his law firm represented the husband only on matters unrelated to estate planning. See Chase v. Bowen, 771 So.2d 1181 (Fla. Ct. App., 2000) (there was no conflict of interest when lawyer revised a will to disinherit a beneficiary whom the lawyer had previously represented on an unrelated matter).

34 Est. Plan. 56, 2007 WL 38759 (W.G.&L.)

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