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A Major IRS Estate Tax Loss

FEBRUARY 14, 2013
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U.S. Tax Court Judge Elizabeth Paris handed the taxpayers a victory last Thursday involving a powerful estate tax planning tool: private annuities.

The case, Estate of Kite v. Commissioner, is important, partly because much of the planning was done in a panic at the end of 2012, for fear that the lifetime exclusion would drop from $5.12 million to $1 million per person, and it involved private annuities.

This case is more important because practitioners will now be emboldened to use private annuities, and a particular version of them—known as deferred private annuities—even more in the future.

The stakes involved were significant: $6 million of gift tax and $5 million of estate tax. The taxpayer came from a wealthy family that was used to doing sophisticated planning, as evidenced by the fact that there were 70 trusts in existence for the benefit of Virginia Kite and her children.

In 2001, Mrs. Kite, age 74, sold her interests in the Kite Family Investment Co. ("KIC"), a Texas general partnership, to her children, for three private annuity agreements. What was striking about this transaction was that the first payments under the private annuity agreements were not due until 10 years later, in 2011. The IRS has issued guidance regarding deferred payment annuities. However, that authority can be read as being for annuities issued by charities. This case is arguably the first example of a deferred private annuity approved between family members for estate tax planning purposes.

The lawyer who presented this transaction to the children told them that if Mrs. Kite survived for 13 years, the children could be insolvent, due to the size of the payments required, were they to rely solely on their existing personal assets. Mrs. Kite did not need the income from the assets since she was the income beneficiary of eight trusts holding nearly $21 million of marketable securities, and had another $3.5 million of assets in her estate.

Mrs. Kite was ill at the time of the sale. However, her physician submitted a letter, as required by IRS regulations, to permit the taxpayer to use the mortality tables upon which the annuity calculations are based, that "there is at least a 50 percent probability that she will survive for 18 months or longer." Mrs. Kite died almost exactly three years after signing the sale agreement. As a result, her children never paid a penny for their interests in KIC.

First, the IRS argued that the transfer of the KIC interests for the annuity was a disguised gift and there was no real expectation of payment. The IRS said that Mrs. Kite's death within 10 years was foreseeable. The IRS cited Mrs. Kite's medical expense deductions of $130,000, $140,000 and $180,000 in the last three years of her life as indicating that her death within 10 years was foreseeable.

The court rejected the IRS arguments, indicating that the medical expenses reflected the fact that Mrs. Kite was a wealthy woman who could afford home health care. The court also noted that the IRS did not challenge the physician's letter on the chances of Mrs. Kite surviving 18 months or longer.

The IRS also said that the lack of security for the annuity agreements, among other things, demonstrated that the transaction lacked economic substance. The court did not address this point, and it is a curious omission. The major treatises on private annuities recommend that the seller not retain a security interest in the transferred property for fear that it will cause estate tax inclusion and immediate gain recognition. (The latter point is usually avoidable because the transaction is consummated with a children's trust which is disregarded for income tax purposes, such as a grantor trust.)

Second, the IRS argued that the annuity transaction was illusory. The taxpayers won this argument for several reasons, one of which will be difficult for most taxpayers to duplicate. Before the private annuity transaction, the children contributed over $13 million in assets to KIC.

In other words, they had substantial assets that they could use to make the payments to their mother. They were not relying simply on the assets they were buying from their mother. The court also cited the fact that Mrs. Kite had actively participated in her finances over her lifetime and demonstrated an immense business acumen. Therefore, she would not have entered into the annuity agreements unless they were enforceable and she could profit from them.

There were other interesting technical issues in the case, primarily involving the marital deduction, specifically the qualifying terminable interest property trust. A QTIP trust allows the estate tax marital deduction for a trust that gives the surviving spouse only a life estate. Section 2519, one of the most difficult sections of the Internal Revenue Code to comprehend, triggers a gift tax when any part of a QTIP is assigned. In this case Mrs. Kite was able to reduce the taxable value of the assets in the QTIP trust by investing them in a limited partnership and, as a result, applying a 34.354 percent lack of marketability and minority interest discount. The court recognized that the mere conversion of the property into other property in which she had a qualifying income interest for life is not subject to Section 2519's gift mechanism.

Private annuities are powerful tools. They give the parents a guaranteed income for as long as either one of them is alive. In exchange, the assets transferred are immediately excluded from the parents' taxable estates.

There are shortcomings, of course, if the transaction relies solely on a private annuity, i.e., if the income from the properties increases over the parents' remaining lives, the parents will not share in that increase. However, that shortcoming can be ameliorated by pairing the private annuity with a promissory note. Kite will make it easier for practitioners and taxpayers to rely on this important structure.

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