

Steve Sternberger's

B·E·S·T

Business and Estate
Strategies and Tips

"The monthly newsletter for the professional insurance representative"

PRIVATE ANNUITIES...ANOTHER TAX PLANNING TOOL ON ITS WAY OUT

On October 17, 2006, the IRS released proposed regulations that will forever change the way private annuity transactions are treated for tax purposes in the future. The regs are proposed generally to be effective for property exchanged for a private annuity after October 18, 2006. For certain private annuity transactions deemed not to be abusive (generally, those which are "unsecured"), the proposed effective date is 6 months later (after April 18, 2007).

My good friend and colleague, Stephan R. Leimberg, publishes several newsletters, many of which seem to come out before the general public even knows something has happened! He has given us permission for certain of his content to be reprinted so that important news gets out quickly without my having to take the time to re-write the article before sending it out. The first of his newsletters on which I am taking him up on his offer appears below. I urge you to read it and to heed both its content and its message. Steve speaks the truth. We have great products that provide tremendous benefits to our clients. The surest way to lose those benefits is to make them appear even better than they intrinsically are!

p.s. If you are interested in receiving information about Steve's newsletters, click on the Email Steve link within Steve's Corner and I'll see that information is sent to you by Leimberg Services, Inc. OMFN receives nothing for providing this service other than the knowledge that interested agents are taking steps to further their knowledge and understanding of the business we're all in.

Good Selling!



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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1037

Date: 17-Oct-06

From: Steve Leimberg's Estate Planning Newsletter

Subject: FLASH - Treasury and IRS Drastically Change Rules on Exchanges for Annuities

Cause and Effect, Cause and Effect, Cause and Effect.

It happens over and over and over - and yet - some folks still don't get it (or could care less about what it does to others - after they get theirs!).

Here's the latest IRS attack on certain private (and other) annuity transactions in which deferral of gain recognition is a principal purpose. (Can you spell Private Annuity Trusts?)

This is strictly a "First Impression" view - and LISI Commentators will be following up soon!

EXECUTIVE SUMMARY:

The Department of the Treasury and the Internal Revenue Service issued proposed regulations under Code Sections 72 and 1001 that would drastically change the tax treatment of an exchange of property for an (private or commercial) annuity contract. This proposed regulation would end tax deferral on such transactions.

FACTS:

For many years now, it has been commonly accepted "settled law" that, upon the exchange of appreciated property for a private annuity, no current taxable event would occur.

Now the IRS is saying that, not only is such a result inconsistent with the tax treatment of exchanges for commercial annuities or other kinds of property, but that the thinking behind the ruling upon which this tax treatment is based (i.e. the "open transaction doctrine, the assumption that the value of a private annuity contract could not be determined for federal income tax purposes) is no longer correct. According to the IRS, that doctrine "has been eroded in recent years."

More importantly, the Treasury Department and the IRS are very much aware that the concept has been abused (or more politely, "relied upon inappropriately in a number of transactions that are designed to avoid U.S. income tax").

According to the Service, " Many of these transactions 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."

The guidance the IRS issued today, October 17, 2006, proposes to declare the ruling upon which tax deferral is based - obsolete. (Charitable gift annuities would not be affected by the proposed guidance.)

GENERAL EFFECTIVE DATE:

The proposed regs will generally be effective for exchanges of property for an annuity contract *after* October 18, 2006. Thus, the regulations would *not* apply to amounts received after October 18, 2006 under annuity contracts that were received in exchange for property *before* that date.

For a *limited* class of transactions, the effective date will be for exchanges of property for an annuity contract after April 18, 2007.

REV. RUL. 69-74 OBSOLETE:

Rev. Rul. 69-74 will be obsolete effective contemporaneously with the effective date of these regulations. Thus, the obsolescence would be effective April 18, 2007 for exchanges described in §1.1001-1(j)(2)(ii) and §1.72-6(e)(2)(ii), and effective October 18, 2006 for all other exchanges of property for an annuity contract.

SPECIAL DELAYED EFFECTIVE DATE FOR NONABUSIVE TRANSACTIONS:

In both regulations, the effective date is delayed for six months for transactions in which

- (i) the issuer of the annuity contract is an individual;
- (ii) the obligations under the annuity contract are not secured, either directly or indirectly; and
- (iii) the property transferred in the exchange is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange.

COMMENT:

WHAT THE REGS DO:

The proposed regulations provide a single set of rules that 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 purchase an annuity contract.

The effect of these proposed regs (which do not distinguish between private annuities and annuities issued by commercial insurance companies) is to treat the seller-annuitant as having realized an amount equal to the fair market value of the contract determined under Code Section 7520 (this provides the actuarial tables which must be used to compute the present value of an annuity).

So if a private annuity promise or a commercial annuity contract is received by the seller in exchange for property (other than cash), the entire amount of the seller's gain or loss (if any) must be recognized *at the time of the exchange!*

No matter what method of account your client uses, he or she will no longer be allowed to defer recognition of gain!

The same rules apply whether the exchange produces a gain or loss.

The proposed regulations apply to exchanges of property for an annuity contract, regardless of whether the property is exchanged for a newly issued annuity contract or whether the property is exchanged for an already existing annuity contract.

One more time: No longer will our clients be able to use the "open transaction doctrine" to defer recognition of gain on an exchange involving a private annuity.

BASIS:

Since the seller-annuitant will now be required to currently report as income all the gain at the date of the transaction, his or her initial "investment in the contract" under Code Section 72(c)(1) (the amount that determines the taxation of future payments from the annuity contract) equals the FMV of the contract.

So where the fair market value of the property exchanged by the seller-annuitant equals the present value of the annuity contract received, the seller-annuitant's investment in the annuity contract equals the fair market value of the property exchanged for the annuity contract.

PART SALE-PART GIFT TRANSACTIONS:

In the case of an exchange of property for an annuity contract that is in part a sale and in part a gift, the proposed regulations apply the same rules that apply to any other such exchange under Code Section 1001.

WHAT THE REGS DO *NOT* DO:

The proposed regulations do *not* alter the existing rules governing tax-free exchanges of annuity contracts under section 1035. They *ONLY* address taxable exchanges of other property for an annuity contract.

The proposed regulations do *not* distinguish between secured and unsecured annuity contracts.

The regulations do *not* prevent the application of other provisions, such as section 267, to limit deductible losses in the case of some exchanges.

Does the Treasury have the authority to go this far this fast? Stay tuned!!!

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Steve Leimberg

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CITES:

Proposed Reg-141901-05 ; Lloyd v. Commissioner, 33 B.T.A. 903 (1936), nonacq., XV-2 CB 39 (1936), nonacq. withdrawn and acq., 1950-2 CB 3 and Rev. Rul. 69-74, 1969-1 C.B. 43; Estate of Bell v. Commissioner, 60 T.C. **469** (1973), acq. in part and nonacq. in part, 1974 WL 36039 (Jan. 8, 1974), acq., AOD No. 1979-184 (August 15, 1979); 212 Corp. v. Commissioner, 70 T.C. 788 (1978); Leimberg and Hodges, "The Income and Estate Planning Advantages of Private Annuities", Estate Planning, February 2006, Vol. 33, No. 2, Pg. 3; Leimberg and Hodges, "Maximizing the Planning Opportunities of Private Annuities", Estate Planning Journal, Mar 2006.