Annuities and Living Proceeds

# Generally

IRC Section 2039 generally governs the federal estate taxation of annuities. This section provides a premium payment test for determining whether, and to what extent, the value of a refund or survivor benefits will be includable in an annuitant’s gross estate. However, IRC Section 2039 applies only when the post-death payments are payable to a beneficiary other than the decedent’s estate. Results under the IRC Section 2039 premium payment test are as follows:

* If the deceased annuitant has paid all of the premiums on the contract, the entire value of the post-death payments is includable in his gross estate.
* If the deceased annuitant has paid only part of the premiums, only a portion of the value of the post-death payments will be includable in his gross estate: the amount includable will be an amount which bears the same ratio to the total value of the post-death benefits as the premiums paid by the annuitant bear to total premiums that have been paid on the contract.
* If the deceased annuitant has paid none of the premiums on the contract, no part of the value of the post-death benefits will be includable in his gross estate under IRC Section 2039.

Contributions made by the decedent's employer to the purchase price of the contract are considered made by the decedent if the contributions are made because of the decedent's employment.

*Example.*Assume at death the value of an annuity payable to a beneficiary is $20,000. Before death, the decedent was receiving payments under the annuity contract. The annuity contract cost $25,000, of which the decedent had paid $15,000. The remaining cost was paid by the decedent's spouse. The value included in the decedent's gross estate is $12,000 ($15,000 ÷25,000 x $20,000). If the annuity was part of a retirement plan and the decedent's employer rather than the spouse had paid the remaining cost, $20,000 ($25,000 ÷$25,000 X $20,000) would be included in the decedent's gross estate.

A pure annuity contract that provides periodic payments to a person for life and ceases at the person's death is not included in the gross estate. Only certain annuities that continue to provide payments to surviving beneficiaries after the decedent dies are includable in the gross estate.

Annuities and Living Proceeds

Specifically, IRC Section 2039(a) provides that: “The gross estate shall include the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement entered into after March 3, 1931 (other than as insurance under policies on the life of the decedent), if, under such contract or agreement, an annuity or other payment was payable to the decedent or the decedent possessed the right to receive such annuity or payment, either alone or in conjunction with another for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death.”

It will be noted that IRC Section 2039 does *not* apply to payments received *as insurance* under policies on the life of the decedent. In other words, it does not apply to payments under a contract which contained an element of insurance risk at the time of the decedent’s death and which matured by reason of the decedent’s death. IRC Section 2042 generally governs the federal estate taxation of life insurance death proceeds.

The applicability of IRC Section 2039 is not limited, however, to payments under annuity contracts. IRC Section 2039 applies also to payment under endowment and life insurance contracts that have matured during the lifetime of the insured. Such payments are not received by the beneficiary *as insurance* on the life of the decedent. Thus, where the decedent has been receiving endowment maturity proceeds or cash surrender values under a settlement option, the inclusion of the value of any refund or survivor benefits in his gross estate will be determined under the provisions of IRC Section 2039.

As stated previously, IRC Section 2039 does not apply if the post-death payments are payable to the decedent’s estate. Payments receivable by his estate are fully includable in his gross estate under IRC Section 2033, which includes “the value of all property to the extent of the interest therein of the decedent at the time of his death.” Thus, the entire value of the post-death payments would be includable, regardless of who paid the premiums on the contract.

IRC Section 2039 does not apply to any contract or agreement made on or before March 3, 1931. Payments under contracts purchased before March 3, 1931 are exempt from federal estate tax unless they are payable to the decedent’s estate.

Employee annuities, as well as personal annuities, come under the provisions of IRC Section 2039. The paragraphs immediately following deal with the application of the estate tax law to specific types of annuities and settlement options.

Annuities and Living Proceeds

# Straight Life Annuity

If the decedent was receiving a straight life annuity (single life, no refund or period certain guarantee), there is no property interest remaining at his death to be included in his gross estate.

# Refund or Period Certain Life Annuity or Settlement Option: Fixed-Period or Fixed-Amount Payments

If the decedent was receiving a life annuity with refund or period certain guarantee and death occurred during the guaranteed period, tax results depend upon whether the balance of the guaranteed amount is payable to the decedent’s estate or to a beneficiary other than decedent’s estate.

If payable to decedent’s estate, the value of the post-death payment or payments is includable in his gross estate under IRC Section 2033, as a property interest owned by him at the time of his death.

But if the balance of the guaranteed amount is payable to a beneficiary other than the decedent’s estate, the provisions of IRC Section 2039 apply and inclusion in the gross estate is determined by a “premium payment” test. It is immaterial whether the beneficiary was named revocably or irrevocably. Thus, if the decedent furnished all of the purchase price of the contract, the full value of the post-death payment or payments is includable in his gross estate. But if the decedent furnished only part of the purchase price, his gross estate includes only a proportional share of this value. If the decedent paid none of the premiums, no part of the value of the post-death payment or payments is includable in his gross estate under IRC Section 2039. See Generally, above. (However, if the contract was purchased before March 3, 1931, IRC Section 2039 does not apply, and the refund is exempt from federal estate tax.)

In *Kasishke v. U.S.*, 426 F.2d 429 (10th Cir. 1970), the decedent was a beneficiary under a single premium 10-year endowment policy she had bought on the life of her husband 28 years before her death in 1963. At the time decedent applied for the policy, she reserved no right to change the beneficiary, no surrender right, no right to any dividends or policy loans and no right to receive the proceeds as an endowment. The application provided that the proceeds of the policy, whether payable upon the death of the decedent’s husband, upon life time maturity or upon surrender of the policy, were to be held at interest, the interest paid to the husband for his lifetime, thereafter to decedent for her lifetime and upon her death to their son, and finally the principal

Annuities and Living Proceeds

distributed to the son’s issue. The beneficiary’s right of withdrawal was specifically withheld. About two weeks after the purchase, decedent made a gift of the policy to her husband. The policy matured during the husband’s lifetime and the settlement option elected by decedent went into effect. The husband died in 1950, and at decedent’s death in 1963, she was the beneficiary of interest payments. At her death, her son started receiving the interest payments. The issue presented to the court was whether the proceeds were includable in decedent’s estate. The court held that the entire proceeds being held at interest *were includable* in decedent’s estate under IRC Section 2036 as a transfer of property with a life interest retained. The transfer was, of course, the gift of the policy to the husband. The court reasoned the decedent had retained a life interest because under the option arrangement she elected at the time of purchase “every possible situation whereby the decedent’s right to interest if she survived her husband might otherwise be defeated was forestalled.” The court found, in summary, that the three predicates for application of IRC Section 2036 were present: (1) there was an inter vivos transfer by decedent by trust or otherwise, (2) the decedent retained the possession or enjoyment of or the right to income from the property, and (3) such retention or reservation was for decedent’s life or for any period not ascertainable without reference to her death or for any period which did not in fact end before her death. The district court had concluded that the proceeds were also includable under IRC Section 2039, but the circuit court expressly reserved judgment on that issue.

In the case of a lump sum payment (as under a cash refund annuity), the value includable is presumably the amount receivable by the beneficiary. Treas. Reg. §20.2031-1(b). In the case of guaranteed installment payments (as under an installment refund annuity or period certain annuity), the value includable is established by the amount the company would charge for a contract paying a comparable annuity. Treas. Regs. §§20.2031-8(a), 20.2031-10(a)(1). Value at date of death is used, even where the executor elects alternate valuation. IRC Sec. 2032(a)(3).

The same rules apply if the decedent was receiving payments under a fixed-period or fixed-amount option. The present value of the remaining payments is includable in the decedent’s gross estate if the payments are receivable by his estate. Otherwise, inclusion in the gross estate is determined under the IRC Section 2039 premium payment test.

# Charitable Organization as Refund Beneficiary

The value of the refund under a refund annuity is not subject to tax in the annuitant’s estate if it is payable to a charitable organization. Although the value of the refund is

Annuities and Living Proceeds

includable in the gross estate, the estate is entitled to a deduction in the same amount for the charitable gift. IRC Sec. 2055.

But where a decedent has directed his executor to purchase a refund annuity for a personal beneficiary, and to name a charitable organization as beneficiary of the refund, decedent’s estate is not entitled to a charitable deduction for the value of the refund. Treas. Reg. §20.2055-2(b); *Choffin’s Est.*, 222 F. Supp. 34 (S.D. Fla. 1963).

# Joint and Survivor Annuity

Where the annuity is a joint and survivor annuity, the question arises as to whether the value of the annuity payable to the survivor is includable in the gross estate of the annuitant who dies first.

IRC Section 2039 controls, and estate taxation is determined by a premium payment test. Thus, if the deceased annuitant paid the full purchase price of the contract, the entire value of the survivor’s annuity is includable in his gross estate. But if the survivor is the purchaser, no part of the value is includable in the deceased annuitant’s estate. If both contributed to the purchase price, only a proportionate part of the value is includable in deceased’s estate. The regulations contain the following example:

“On January 1, 1945, the decedent and his wife each contributed $15,000 to the purchase price of an annuity contract under the terms of which the issuing company agreed to pay an annuity to the decedent and his wife for their joint lives and to continue the annuity to the survivor for his life. Assume that the value of the survivor’s annuity at the decedent’s death (computed under §20.2031-8) is $20,000. Since the decedent contributed one-half of the cost of the contract, the amount to be included in his gross estate under section 2039(a) and (b) is $10,000.” Treas.  Reg. §20.2039-1(c)(Ex. 1).

In accord with this rule, if a joint and survivor annuity is purchased with community funds, only one-half of the value of the survivor’s annuity is includable in the gross estate of the spouse who dies first. *Est. of Mearkle*, 129 F. 2d 386 (3rd Cir. 1942); *Comm. v. Wilder’s Est.*, 118 F. 2d 281 (5th Cir. 1941).

The purchase of a joint and survivor annuity by one annuitant constitutes a gift to the other annuitant. Treas. Reg. §25.2512-6. Nevertheless, under the premium payment test of IRC Section 2039, the value of the survivor’s annuity will be included in the purchaser’s gross estate if he dies first.

Annuities and Living Proceeds

However, the interest of a donee spouse in a joint and survivor annuity in which only the donor and donee spouses have a right to receive payments during such spouses’ joint lifetime is treated as qualifying terminable interest property (QTIP) for which the marital deduction is available unless the donor spouse irrevocably elects otherwise within the time allowed for filing a gift or estate tax return. IRC Secs. 2056(b)(7)(C), 2523(f)(6). Nevertheless, if the donee spouse dies before the donor spouse, nothing is included in the donee’s estate by reason of the qualifying income interest. IRC Sec. 2523(f)(6). Generally, this provision is effective with respect to decedents dying, and gifts made, after 1981. However, this provision did not apply with respect to any estate or gift tax return filed before November 11, 1988 to the extent inconsistent with the treatment of the annuity on such a return, unless an election was made before November 12, 1990. In any event, an election out of QTIP treatment could be made at any time before November 12, 1990 (i.e., the estate and gift tax deadline for making the election was extended for a transitional period). TAMRA ’88, Sec. 6152(c).

Also, where the survivor is the deceased annuitant’s spouse, the value of the survivor’s annuity will qualify for the marital deduction if the contract provides no refund upon the death of the survivor, or provides that any refund is payable to the estate of the survivor. Treas. Reg. §20.2056(b)-1(g)(Ex. 3).

The value of the survivor annuity for estate tax purposes is the amount the same insurance company would charge the survivor for a single life annuity as of the date of the first annuitant’s death. Treas. Reg. §20.2031-8; see also, *Est. of Mearkle*, 129 F. 2d 386 (3rd Cir. 1942); *Christiernin v. Manning*, 138 F. Supp. 923 (D. N.J. 1956); *Est. of Pruyn*, 12 TC 754 (1949); *Est. of Welliver*, 8 TC 165 (1947).

However, where it can be proved that the survivor’s life expectancy is below average, it may be possible to obtain a valuation based upon the survivor’s actual life expectancy. For example, a lower valuation has been obtained upon proof that the surviving annuitant’s life expectancy was short because of an incurable disease. *Est. of Denbigh*, 7 TC 387 (1946), acq. 1953-1 CB 4; *Est. of Hoelzel*, 28 TC 384 (1957), acq. 1957-2 CB 5.

Even if the executor elects to value estate assets on the alternate valuation date, the survivor’s annuity is valued at date of death. (Date of death value is used, even where alternate valuation is elected, where any change in value during the year following death is due only to the lapse of time.)

But if the surviving annuitant dies during the year following the first annuitant’s death, a lower valuation may be obtained by electing the optional valuation date. For example,

Annuities and Living Proceeds

where alternate valuation was elected, and the survivor died during the year following the first annuitant’s death, the value of the survivor’s annuity was determined by subtracting the cost of an annuity as of the survivor’s date of death from the cost of an annuity as of the first annuitant’s date of death. *Est. of Hance*, 18 TC 499 (1952).

Qualified Plan Survivor Annuities

Qualified plans frequently provide annuity payments to a surviving spouse of the participant. The arrangement may be either a qualified joint and survivor annuity (QJSA), under which the annuity payments begin during the life of the participant and continue until the death of the second spouse to die, or a qualified pre-retirement survivor annuity (QPSA), under which a surviving spouse is entitled to an annuity even if the participant dies before the annuity starting date. The value of the surviving spouse's interest in either form of survivor annuity is includable in the decedent's gross estate, but the same amount would qualify for the marital deduction.

Joint Life Annuity

A joint life annuity is different from a joint and survivor annuity because the joint life annuity is payable only while both annuitants are alive. Because the annuity terminates at the death of the first to die, nothing is includable in the gross estate of either annuitant.

# Survivorship Annuity

The survivorship annuity, or “reversionary annuity,” is not really an annuity but a life insurance contract.*Cowles v. U.S.*, 59 F. Supp. 633, 634 (SDNY 1945), reversed on another issue, 152 F. 2d 212 (2nd Cir. 1945). The contract promises to pay a life income of a specified amount to a designated beneficiary if the beneficiary should survive the insured. However, if the beneficiary should die first, the contract terminates and no benefits are payable. Such contracts are issued only on evidence of insurability. IRC Section 2039 is not applicable to benefits received *as insurance* on the life of the decedent. Consequently, IRC Section 2042, rather than IRC Section 2039, should govern the estate taxation of benefits under a survivorship annuity.

Contracts providing for the payment of a life annuity to another, commencing upon the purchaser's prior death, have been held to be life insurance and taxable under Code section 2042. Survivorship annuities are issued only on evidence of insurability, and when the element of risk-shifting is involved. *Cowles v. U.S*., 152 F.2d 212.  Code section 2039 excludes agreements that constitute insurance on the decedent's life.

Annuities and Living Proceeds

# Death Benefit under Retirement Annuity

Retirement annuity contracts provide for the return of premiums or the cash value, whichever is greater, in the event of death before maturity. Therefore the payments are not classified as life insurance for two reasons. First, there is no risk-shifting and second, evidence of insurability is not required.  *Helvering v. Le Gierse*, 312 U.S. 531; Reg. §20.2039-1(d). When the return of premiums or the cash value is paid to the annuitant's estate, the value of the payment is included in the gross estate under Code section 2033.When paid to the annuitant's designated beneficiary, the value of the payments to be made at or after death is includable in the gross estate under Code section 2039.

The death benefit payable under a retirement annuity where the annuitant dies before the contract matures is not life insurance. The estate tax rules for annuities apply. Treas. Reg. §20.2039-1(d). If the death benefit is payable to the deceased annuitant’s estate, its value is includable in his gross estate under IRC Section 2033, as a property interest owned by him at the time of his death. If the death benefit is payable to a beneficiary other than the annuitant’s estate, the premium payment test of IRC Section 2039 applies (see Generally, above).

# Retirement Income Contract

Some years before the maturity of a retirement income contract the reserve equals, then exceeds, the face amount. The estate tax treatment of death proceeds payable under such a contract will depend upon whether death occurs before or after the reserve reaches the face amount.

If the insured dies before the reserve equals the face amount, the proceeds are payable as insurance, and IRC Section 2042 applies. Generally, this means that the proceeds are includable in the insured’s gross estate if he possesses incidents of ownership in the contract at the time of his death. But if the insured dies after the reserve equals the face amount, IRC Section 2039, relating to the taxation of annuities, applies. Generally, this means that includability in the gross estate is determined by the “premium payment test” (see Generally, above). In either case, however, the proceeds are includable in the insured’s gross estate if they are payable to his estate. IRC Secs. 2042(1), 2033.

# Gift of Annuity: Decedent as Refund Beneficiary

Suppose an individual purchases an annuity on the life of another person as a gift to that person, and the donor dies first. If the donor retained no ownership rights in the

Annuities and Living Proceeds

contract and no interest in the annuity payments or refund, ordinarily no part of the value of the annuity will be includable in his gross estate.

And if the deceased donor has named himself as refund beneficiary, the value of the refund is includable in his gross estate under IRC Section 2037 (as a transfer taking effect at death) provided the value of the refund exceeds 5% of the value of the annuity immediately before the donor’s death. The value of the refund (reversionary interest) is zero, however, if the donee-annuitant has the power to surrender the contract or to change the refund beneficiary. Consequently, such power in the donee-annuitant apparently precludes taxation of the refund in the donor’s estate as a transfer taking effect at death. IRC Sec. 2037(b); see *Hofford’s Est.*, 4 TC 542 (1945).

Moreover, if the donor irrevocably names one person to receive the income for life, and irrevocably names another to receive the refund, the value of the refund should not be includable in the *donee-annuitant’s* gross estate. IRC Section 2039 is not applicable here, because the donee-annuitant is not the purchaser of the contract.

However, where decedent and another each paid 50 percent of the purchase price for an annuity upon a third person, reserving to themselves or the survivor the right to surrender the contract, one-half its cash surrender value was included in decedent's gross estate.  *Wishard v. U.S*., 143 F.2d 704. The court held these circumstances outside the general rule of the regulations. Transfer to the other co-owner was of the surrender right only—not the right to receive annuity payments.

# Private Annuity

A private annuity is a contract between two individuals (obligor and annuitant) to exchange a valuable asset in return for a lifetime of fixed payments. A private annuity differs from a commercial annuity. The typical private annuity is the transfer of appreciated property from parents to children or grandparents to grandchildren. Private annuities are valued in accordance with IRS actuarial tables, which appear in Treas. Reg. §20.2031-10(f).

In the usual private annuity transaction, where the decedent is the sole annuitant, the annuity ceases at the decedent’s death and there is nothing to be taxed in his estate. If, however, under the terms of the private annuity agreement, benefits are payable to a survivor, the value of such benefits is includable in decedent’s estate.

If the transaction resulted in a gift from the annuitant to the obligor, annuitant’s death within three years of the transaction may result in the value of the gift (plus gift tax paid) being included in the deceased annuitant’s gross estate. If annuitant’s death does not

Annuities and Living Proceeds

occur within three years, but the gift was a *taxable* gift, the gift will be an *adjusted taxable gift* for purposes of the estate tax computation in the annuitant’s estate.

In the usual private annuity transaction, the annuitant’s transfer of the property given in exchange for the annuity is complete and absolute. Under such circumstance, no part of the transferred property is includable in the annuitant’s estate. If, however, the annuitant retains at his death an interest in the property transferred, the value of the property could be includable in his gross estate under such of IRC Sections 2033, 2036, 2037 or 2038 as may be appropriate under the circumstances.

Valuation of Private Annuities

Annuities are generally valued with use of the government's valuation tables. Before 1996, the government's tables were required as a tool for valuation of annuities "unless death was imminent.”  Rev. Rul 80-80, 1980-1 C.B. 194. In 1996, the government changed its position. The government’s valuation tables are not to be used if

* the individual who is the measuring life is terminally ill;
* use of the table would "violate reason and fact";
* the trust is expected to exhaust the fund before the final annuity payment is paid; and
* the tables are used to value an income interest under certain circumstances.

The tables in the regulations discount future payments at 10 percent compound interest. A different rate can be used when the facts require. For example, if a trust fund yields only 4 percent interest, the valuation interest rate should also be 4 percent.

Using Private Annuities to Transfer Property Interests

The private annuity is an effective tool for the transfer of a business or investment interest when a taxpayer wants to enjoy the proceeds of appreciated property while keeping the principal out of the estate. Typically, a parent or grandparent will transfer an investment or business interest to a child or grandchild while retaining the income from the investment or business interest. However, the IRS holds that this type of transfer will cause the principal to remain in the taxpayer's estate.

In return for the sale of the interest or investment a child or grandchild can enter into an agreement to pay an annuity based on life expectancy. This arrangement is contractual

Annuities and Living Proceeds

and legally enforceable. As a result the former property owner will enjoy the income, and upon the taxpayer's death the annuity will be considered to have no value and will not be included in the decedent's gross estate. Care should be taken that the payment is not less than that prescribed by a life expectancy table, otherwise the IRS can claim that children have paid for the property at less than its true value, and gift taxes may apply.

The preceding must be weighed against regulations proposed by the IRS in October 2006 concerning the taxation of the compensation received by the annuitant for the transfer of the interest.  Before the regulations, the annuitant recognized gain on the transferred property over the life of the annuity, as generally prescribed by Code section 72.  Seeking to curb arrangements by which annuitants tried to avoid recognizing the gain, the regulations require that gain be recognized in the year the transfer is complete.  Even where clearing the appreciated property or business interest from the estate is the primary motive for the transfer, the regulations may have an ancillary effect that must be considered.

# Combination Life and Annuity Contracts

Combination life and annuity contracts are available through some companies. A combination life and annuity contract (105 percent or 110 percent plan) is a single premium nonrefund annuity and a life insurance policy. As a result of the combination, the risk of early death is offset against the risk of long life.

Death benefits payable under combination contracts are not considered life insurance proceeds for estate tax purposes.  *Helvering v. Le Gierse*, 312 U.S. 531 (1941). Because the combined single premium exceeds the death benefit by 5 percent to 10 percent, no risk shifting or risk distributing takes place. Consequently, Code section 2042 will not apply.

If the policyholder owns the insurance contract, the death benefits are includable in the decedent's gross estate.  IRC Sec. 2033. The benefits can also be included under Code section 2039 as an annuity with a death benefit.