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Proposed regs. impact taxation of annuity for property exchanges

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Private annuity transactions between family members have been a popular estate planning mechanism. In a typical arrangement, a parent transfers appreciated property to a younger family member in exchange for the younger individual's promise to pay a lifetime annuity to the parent. This provides an income stream to the parent, while eliminating the appreciated asset from the parent's taxable estate.

The IRS has proposed regulations that would dramatically alter the income tax consequences of such an arrangement. The proposed regulations provide that, when an annuity is exchanged for property other than money: (i) the full gain or loss will be recognized at the time of the exchange, and (ii) the amount realized will be the annuity's fair market value as determined at the time of the exchange. Thus, under the proposed regulations, taxpayers would no longer be able to defer gain on these types of exchanges. Instead, taxpayers would be taxed in full at the time of the initial exchange, based on the then-fair market value of the annuity received.

The proposed regulations apply to both private and commercial annuity contracts. The regulations are generally effective for exchanges of property for an annuity contract occurring after October 18, 2006. However, the effective date if delayed until April 18, 2007 for transactions in which (i) the issuer of the annuity is an individual, (ii) the obligation under the contract is not secured, and (iii) the exchanged property is not sold or otherwise disposed of by the transferee during the two-year period following the exchange.

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