

**PLANNING FOR INDIVIDUALS WITH  
DIMINISHED LIFE EXPECTANCY**

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# PLANNING FOR INDIVIDUALS WITH DIMINISHED LIFE EXPECTANCY

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## I. INTRODUCTION.

Each year, thousands of Americans receive a diagnosis that can be devastating. Certain forms of cancer, ALS, and other ailments may shorten a person's life expectancy from decades to just a year or two.

Personal concerns, of course, always take precedence. But the practical reality is that property and taxes must also be managed. Very ill individuals may be able to use estate planning strategies that are not otherwise available to those with a normal life expectancy. As an advisor, it is important to understand the situations in which these strategies might become available and to be able to discuss the advantages and disadvantages of the individual's various options.

This article will examine some of the estate planning strategies that may be advantageous to those with a diminished life expectancy, including private annuities, charitable lead trusts, self-cancelling installment notes, and the sale of a remainder interest in a qualified personal residence trust.

## II. SECTION 7520 VALUATION TABLES.

Section 7520 of the Internal Revenue Code (the "Code") provides that the fair market value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest, must be determined by using the tables prescribed by the IRS and by assuming a specified interest rate calculated monthly by the IRS (the "7520 Rate"). The 7520 Rate is equal to 120 percent of the mid-term Applicable Federal Rate<sup>1</sup> (rounded to the nearest 2/10ths of 1 percent). The 7520 Rate for November 2021 is 1.4 percent.

### A. Favorable Use of IRS Tables When Actual Life Expectancy is Reduced.

The mortality tables prescribed under Section 7520 are based on statistical averages derived from U.S. census mortality data. The current mortality tables are set forth in Temp. Treas. Reg. § 20.2031-7T. Because of the black-and-white nature of the life expectancies provided in the mortality tables, favorable estate planning opportunities can arise for an individual who, due to a health condition, has an actual life expectancy that may be less than the IRS's valuation tables would indicate but who is not considered "terminally ill" as defined by the Treasury regulations. For example, a person who has a life expectancy of 20 years according to the IRS's actuarial tables, but is actually expected to live for only two more years, should be able to take advantage of the favorable estate planning techniques described below.

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<sup>1</sup> The Applicable Federal Rate is determined monthly by the IRS based on the average market yield during the one-month period on outstanding U.S. Treasury notes. The IRS calculates a short-term Applicable Federal Rate, mid-term Applicable Federal Rate and long-term Applicable Federal Rate.

## **B. Valuation Tables Inapplicable for the “Terminally Ill.”**

The regulations under Section 7520 provide that the mortality tables may not be used for an individual who is “terminally ill.” Treas. Reg. §§ 1.7520-3(b)(3), 20.7520-3(b)(3)(i), 25.7520-3(b)(3)(i). For purposes of the Treasury regulations, an individual who is known to have an incurable illness or other deteriorating physical condition is considered “terminally ill” if there is at least a 50 percent probability that the individual will die within 1 year. *Id.* For example, in T.A.M. 9504004 (Jan. 27, 1995), the taxpayer had been diagnosed with lung cancer and had been told by doctors that her condition was terminal. Soon after tests had revealed her condition to be terminal, the taxpayer entered into a series of estate planning transactions including the sale of stock to her child in exchange for an annuity. The amount of the annuity was determined in accordance with the IRS actuarial tables for a person of her age. The donor died one month after the transactions and after having received only one monthly annuity payment from her child. The National Office advised that at the time of the transaction, the taxpayer was afflicted with a fatal and incurable disease, and it was predictable to a reasonable certainty that her life expectancy was one year or less requiring departure from the actuarial tables in determining the value of the annuity received in the sale transaction.

If the individual survives for eighteen months or longer after the date of the transaction, the individual is presumed not to have been terminally ill at the date of the transaction unless the contrary is established by clear and convincing evidence. Treas. Reg. §§ 1.7520-3(b)(3), 20.7520-3(b)(3)(i), 25.7520-3(b)(3)(i). Further, as a practical matter, if the individual lives for at least one year it will be difficult for the IRS to argue that the individual was unlikely to do so.

## **III. PRIVATE ANNUITIES.**

A private annuity is perhaps the most common and effective estate planning technique for persons with a diminished life expectancy.

### **A. General Structure.**

A private annuity transaction involves the sale of property in exchange for the promise to pay a fixed amount each year (or other interval) for a period of time. The type of private annuity relevant here uses the lifetime of the annuitant as the annuity term.

**Example:** Ann is 65 years old and has a life expectancy of 20 years according to the Section 7520 tables. In November 2021, Ann is diagnosed with a life-threatening illness and is told by her doctors that she will probably only live two more years. Ann enters into a private annuity transaction with her grandson, Bob, whereby Ann sells Blackacre having a fair market value of \$1,000,000 to Bob in exchange for an annual payment of \$65,719 for Ann’s lifetime.

**B. Gift Tax Consequences.**

If the *expected present value* of the annuity payments over Ann's lifetime (determined using the Section 7520 tables) is equal to the fair market value of the property, there should be no gift for Federal gift tax purposes as a result of the transaction. In the above example, the annual payments of \$65,719 over Ann's lifetime have a present value that should result in no gift tax consequences to Ann.

**C. Estate Tax Consequences.**

If structured properly, upon the death of the seller, the property sold in exchange for a private annuity should not be included in the seller's estate for federal estate tax purposes. So in our example above, if Ann were to die after only two years and two annuity payments made by Bob, he will have actually paid only \$131,438 for Blackacre. The remaining \$868,562 of value, plus any appreciation from the time of the sale, would have passed to Bob free of estate and gift taxes.

**D. Income Tax Consequences.**

Previously, the IRS took the position that gain would be recognized gradually from a portion of each annuity payment, allowing favorable income tax deferral in private annuity transactions. In Revenue Ruling 69-74, the IRS ruled that, in the exchange of property with a family member for an annuity, gain is recognized ratably from the annual payments received over the period of years measured by the annuitant's life expectancy. The payor of the annuity would ultimately take a basis in the property equal to the annuity payments actually made.

However, in 2006, the IRS issued proposed regulations altering the treatment of gain recognition in private annuity transactions. The proposed regulations provide that the entire amount of the gain in a private annuity transaction is recognized immediately at the time of the exchange. Prop. Reg. 1.1001-1(j)(1). Although the regulations have not yet been finalized, they are proposed to be effective for annuity transactions after October 18, 2006. Therefore, income tax deferral in private annuity transactions may no longer be available, making private annuities a somewhat less desirable planning vehicle for low-basis assets.

**IV. SELF-CANCELLING INSTALLMENT NOTE.**

A self-cancelling installment note, or SCIN, is a promissory note that is automatically cancelled in the event that the lender dies before the note comes due. To compensate the lender for this risk, the SCIN must contain a risk premium reflected as an upward adjustment of either the principal or the interest rate (based on the term of the loan and the lender's life expectancy). A SCIN might be appealing if the lender's actual life expectancy may be less than the IRS's actuarial tables would indicate. The SCIN would have a maturity date before the end of the seller's life expectancy, but the unpaid balance would be forgiven if the seller dies before the SCIN's maturity date. However, for reasons discussed below, use of a SCIN generally seems inadvisable for a client who is known to have a greatly diminished life expectancy.

**A. Estate Tax Consequences.**

If property is sold in exchange for a properly structured SCIN and the seller dies before the SCIN term is completed, the property sold and the remaining balance on the note should not be included in the seller's gross estate for Federal estate tax purposes.

In *Estate of Moss v. Commissioner*, 74 T.C. 1239 (1980), a 72-year-old shareholder of a corporation redeemed his stock in exchange for SCINs with a 9 year and 7 month term. At the time he entered the transaction, there was nothing to indicate that his life expectancy was below the approximately 10 year life expectancy average of a 72 year-old. Almost a year later, it was discovered that he had developed cancer, and he died a year and a half after the transaction. The court held that since the decedent's sale of the stock for the SCINs was a bona fide sale for adequate and full consideration, the cancellation provision was part of the bargained for consideration of the sale. The court further held that since there was no interest in the SCINs remaining at the decedent's death, the SCINs are not includable in his gross estate.

In G.C.M. 39503 (May 7, 1986), the IRS Chief Counsel's Office determined that if a SCIN expressly contains a cancellation-on-death provision in the sales agreement and the notes, the SCIN will not be included in the transferor's gross estate for estate tax purposes.

**B. Gift Tax Consequences.**

In determining whether the seller has made a taxable gift in a SCIN transaction, the key question is whether the risk premium was adequately valued. The IRS has said that, unlike private annuities, in SCIN transactions "there is no requirement that the actuarial tables are to be used in determining the gift taxation of installment sale. Thus, the taxpayer's particular health status may be considered . . . ." *Id.* While the risk premium for a SCIN does not necessarily require referencing the IRS actuarial tables, doing so should provide greater certainty that the value of the risk premium will be respected by the IRS absent an indication that the seller's actual life expectancy is less than the actuarial life expectancy under the tables. Because the actuarial life expectancy is not required to be used in valuing the risk premium of a SCIN, it may be more difficult to justify the use of the actuarial life expectancies in valuing SCINs, particularly when the actual life expectancy is predicted to be much shorter than the actuarial tables indicate. This suggests that a private annuity should be used, rather than a SCIN, for clients who are known to have a greatly diminished life expectancy.

**C. Income Tax Consequences.**

The seller in a SCIN transaction may report gain from the sale of a capital asset ratably over the period during which payments are received. *Id.* Upon the death of the seller during the term of the SCIN, the deferred gain under the SCIN probably must be recognized by the seller's estate as IRD under Section 691(a)(5) of the Code. *Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993); Rev. Rul. 86-72. The negative impact of this gain recognition can be reduced by reflecting the risk premium for the cancellation feature in the interest rate rather than in the principal amount, but this will also leave the transferee with a lower basis. See I.R.C. §§ 691(a)(2), (a)(4)(B), and (5)(B).

## V. CHARITABLE LEAD TRUSTS.

A charitable lead trust may also be particularly useful for individuals with a diminished life expectancy because of the way the Section 7520 valuation tables are applied. Below is a general description of how a charitable lead trust might be used in this context and its federal tax consequences.

### A. General Structure.

A charitable lead trust is a type of trust in which a charitable organization is entitled to either a fixed annuity payment each year from the trust for a term of years (a Charitable Lead Annuity Trust or “CLAT”) or a fixed percentage of the trust’s assets determined annually for a term of years (a Charitable Lead Unitrust or “CLUT”). At the expiration of the annuity or unitrust term, the remaining assets of the trust are paid to individual beneficiaries (such as the donor’s children or grandchildren). When the charitable term of a charitable lead trust is tied to the donor’s lifetime, the charitable lead trust can be an attractive estate planning tool for a donor with a diminished life expectancy. Below are examples of a CLAT and a CLUT.

**Example (CLAT):** Ann is 65 years old and has a life expectancy of 20 years according to the Section 7520 tables. In November 2021, Ann is diagnosed with a life-threatening illness and is told by her doctors that she will probably only live two more years. Ann creates a charitable lead trust that pays University an annuity of \$50,000 per year for the remainder of her lifetime. The assets contributed to the trust have a fair market value of \$1,000,000. Upon Ann’s death, the remaining assets of the trust are to be distributed to her grandson, Bob.

**Example (CLUT):** Assume the same facts as in Example 2 except that the charitable lead trust pays University a unitrust interest equal to 5% of the trust’s assets per year for the remainder of her lifetime. Upon Ann’s death, the remaining assets of the trust are to be distributed to her grandson, Bob.

### B. Gift Tax Consequences.

When a donor creates a charitable lead trust, the donor is deemed to have made a gift to the noncharitable remainder beneficiary, but the amount of the gift is reduced by the value of the charity’s interest in the trust (determined using IRS actuarial tables) at the time the trust is created.

In the CLAT example above, the present value of the University’s interest is \$728,742. Therefore, the taxable gift made by Ann in creating the CLAT is \$271,258. If Ann were to die after two years, the school will have received \$100,000. The rest of the property, plus any appreciation after the CLAT was created, should pass to Bob free of gift tax. If the property contributed to the CLAT grows at a rate of 5 percent each year, Bob’s interest at the end of the two years would be worth \$1,000,000.

In the CLUT example above, the present value of the University’s interest is \$555,200. Therefore, the taxable gift made by Ann in creating the CLUT is \$444,800. If the property contributed to the CLUT grows at a rate of 5 percent each year, and if Ann were to die after two

payments, the school will have received \$100,000 and Bob's interest at the time the trust terminates would be worth \$1,000,000.

If the payout to charity is sufficiently large and/or the term over which the charity is anticipated to receive payments is sufficiently long, the amount of the gift to the remainder beneficiaries may be very small (but never zero for a CLUT, and never zero for a CLAT based on a person's life expectancy). Note that for a charitable lead trust, the donor has the ability to choose between the 7520 Rate in effect for the month the gift is made or the 7520 Rate for either of the preceding two months.

**C. Estate Tax Consequences.**

If the donor has not retained impermissible powers over the trust assets, the trust assets should not be included in the donor's estate upon the donor's death for estate tax purposes.

**D. Income Tax Consequences.**

If the charitable lead trust is not structured as a grantor trust for federal tax purposes, the donor will not receive an income tax charitable deduction for the transfer to the charitable lead trust and the donor will not be taxed on the charitable lead trust's income. If the trust is structured as a grantor trust for federal tax purposes, during the charitable term of the trust, the donor will report all of the trust's taxable income, deductions, losses, etc. on the donor's individual income tax return and the donor will receive an income tax charitable deduction up to the present value of the charity's interest in the charitable lead trust.<sup>2</sup> If the donor ceases to be treated as the owner of the lead interest for income tax purposes before that interest terminates, that will trigger recapture of the income tax deduction (less the discounted value of the income taxed to the donor up to that point). Treas. Reg. § 1.170A-6(c)(4). However, if the donor ceases to be treated as owner of the lead interest *upon* the termination of that interest – as would be the case if the donor's death terminates the interest – then this section of the regulations would not seem to apply and the donor may avoid recapture. The author is aware of no authorities definitively addressing that issue.

**E. GST Issues.**

The federal generation-skipping transfer ("GST") tax is designed to prevent the avoidance of estate tax by making transfers through trusts or by other means that would avoid estate tax in subsequent generations. The GST tax is generally imposed on, among other types of transfers, the termination (by death, lapse of time, release of power, or otherwise) of an interest in trust property resulting in the interest or property passing to persons more than one generation below that of the grantor. I.R.C. § 2612. A charitable lead trust will generally be subject to the GST tax at the end of the charitable term if the trust terminates in favor of individuals below the grantor's generation.

Amounts in the charitable lead trust to which the donor's GST exemption has been allocated are not subject to the GST tax. However, for GST tax purposes, the value of the property transferred to the remainder beneficiaries of a CLAT is not determined until the trust terminates.

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<sup>2</sup> Because gifts to a charitable lead trust are treated as gifts "for the use of" the charity, the income tax charitable deduction is limited to 30 percent of the donor's contribution base. I.R.C. § 170(b).



I.R.C. § 2642(e). If, upon creation of the CLAT, the donor allocates GST exemption equal to the taxable portion of the transfer and the amount actually passing to the individual beneficiaries after the expiration of the charitable annuity term is greater than the exemption allocated to the CLAT (subject to certain adjustments<sup>3</sup>), the trust will be only partially exempt from GST tax.

In contrast, a CLUT can be used to leverage the GST exemption as well as gift tax exemption. In a CLUT, the asset value passing to the charitable beneficiary is redetermined each year, and the special GST rules that apply to CLATs do not apply to CLUTs. The GST exemption can be allocated to a CLUT at the time the assets are transferred to the CLUT. If the GST exemption is allocated to the entire value of the remainder interest as of the time the assets are contributed to the CLUT, upon the expiration of the charitable term, the assets passing to the individual beneficiaries (or perhaps a trust for their benefit) should be free of GST tax.

#### **F. Forms.**

The IRS issued revenue procedures in 2007 and 2008 providing annotated forms for various types of charitable lead trusts. Rev. Proc. 2007-45, 2007-29 IRB 89 (for inter vivos CLATs); Rev. Proc. 2008-45, 2008-30 IRB 224 (for inter vivos CLUTs).

### **VI. SALE OF REMAINDER INTEREST IN QPRT.**

Another strategy that may be appropriate for an individual with diminished life expectancy involves the use of a Qualified Personal Residence Trust (a “QPRT”). A QPRT is a type of trust where the grantor retains the right to use a residence for a specified period, but gives someone else (typically the grantor’s children) ownership of the residence following that period. The grantor is normally considered to have made a gift when the QPRT is established, in an amount equal to the present value of the remainder interest determined using the IRS actuarial tables.

#### **A. Sale of Remainder Interest.**

Under a variation of the typical QPRT arrangement, the remainder beneficiaries purchase their remainder interest in the QPRT from the owner by paying for their respective interests in the QPRT (again using the actuarial tables to determine the value) rather than receiving the remainder interest as a gift. One advantage of this variation is that the seller should not be considered to have made a gift and therefore should not incur gift tax. More importantly, because the seller has not made a transfer for less than adequate and full consideration, it appears that the QPRT should not be included in the seller’s gross estate for federal estate tax purposes even if the seller retains the use of the property through the date of the seller’s death. I.R.C. § 2036(a). Further, it may be possible for the owner to sell the remainder interest to an existing trust that is exempt from GST tax. However, the IRS refuses to rule on the estate tax or generation-skipping transfer tax consequences of such a sale, so the seller should be aware that it carries greater risk in this regard. Further, in a typical “gift” QPRT, the grantor retains a reversion (causing the trust assets to revert to the grantor’s estate if he dies during the trust term) so as to further depress the value of the remainder interest. In the

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<sup>3</sup> The exemption allocated to the trust is augmented by “compounding” the exemption at the 7520 Rate until the charitable interest terminates. I.R.C. § 2642(e). For example, if \$1,000,000 of GST exemption is allocated to a CLAT, the 7520 Rate is 1.0%, and the CLAT terminates after one year, then the adjusted GST exemption will be \$1,010,000.

“sale” scenario, it is not appropriate for the seller to retain a reversion (as the buyer might then get nothing), so the value of the remainder interest will be higher.

## **B. Death of Seller.**

If the seller dies within the QPRT term (as will always be the case if the term is defined as the seller’s lifetime), the IRS may take the position that the QPRT is includible in the seller’s estate for Federal estate tax purposes. Section 2036(a)(1) of the Code includes in the decedent’s gross estate for federal estate tax purposes the value of an interest in property if it is transferred by the decedent and the decedent retains until death the possession or enjoyment of, or the right to the income from, the property transferred unless the transfer is a bona fide sale for full and adequate consideration in money or money’s worth. I.R.C. § 2036(a)(1). The IRS has taken the position that if an owner of property sells the remainder interest, the entire property, less the consideration paid by the remaindermen, will be includible in the seller’s estate under Section 2036(a)(1) if the seller has the right to use the property at death and the purchase price of the remainder interest was for less than the full value of the entire property. *See Gradow v. U.S.*, 897 F.2d 516 (Fed. Cir. 1990).

In *Wheeler v. U.S.*, the Fifth Circuit rejected the position of the IRS, holding instead that “the sale of a remainder interest for its actuarial value as calculated by the appropriate factor set forth in the Treasury Regulations constitutes an adequate and full consideration under section 2036(a).” 116 F.3d 749 (5th Cir. 1997). Nevertheless, clients should be aware of this issue when considering the sale of a remainder interest in a QPRT.

## **C. Example.**

Ann is 65 years old and has a life expectancy of 20 years according to the Section 7520 tables. In November 2021, Ann is diagnosed with a life-threatening illness and is told by her doctors that she will probably only live two more years. Ann contributes her residence with a fair market value of \$1,000,000 to a QPRT with a term of Ann’s lifetime. Ann’s grandson, Bob, purchases the remainder interest in the QPRT for \$786,970 (the present value of the remainder interest under the IRS actuarial tables).

If Ann dies in two years, and if the value of the residence appreciates at 5 percent per year, the value of the residence when Bob receives it would be \$1,102,500, avoiding transfer taxes with respect to \$315,530 of the value of the residence.

## **VII. CONCLUSION.**

Techniques such as private annuities, charitable lead trusts, and sales of remainder interests in QPRTs can provide favorable estate planning opportunities for individuals who have a diminished life expectancy and who are not considered “terminally ill” as defined by the Treasury regulations. Income tax concerns, GST tax concerns, and the charitable inclination of the particular client are some of the factors that may make one strategy more appropriate for the individual than another. When approached by clients who have been given the unfortunate news that they have a diminished life expectancy, practitioners should be aware of the strategies available and the federal tax consequences that can result from the various approaches that might be taken.