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Estate of Virginia Kite v. Commissioner T.C. Memo 2013-43
filed February 7, 2013

This important decision allowed a decedent to exclude from her estate a significant amount of wealth by using annuities tailored to the best estimate of her medical condition. In 2001, Mrs. Kite was 74 old, not terminally ill but in poor health and desirous to do more estate planning. She was sophisticated in business and legal matters; her attorney suggested a simple method to take assets out of her trusts to benefit her children: the use of a private deferred annuity.

In 2001, her trusts sold their remaining interests in Kite Family Investment Co., a Texas general partnership, in exchange for 3 deferred private annuities each for the benefit of each of her 3 children. KIC held notes, various investments and publicly traded securities. The KIC interests were valued at $10.6 million when transferred based on the liquidation value; the annuities were valued as prescribed by IRC section 7520 and the IRS actuarial tables prescribed by Notice 89-24 [1989-1.]

Each of the private annuities provided income, but that income was deferred for ten years since Mrs. Kite did not need current income for the foreseeable future. The question for the Tax Court: since no money changed hand, was this a sale for full and adequate consideration of the KIC interests? The Service did not think so, on the belief that the transaction was merely a disguised gift. Both a notice of deficiency relating to the gift return and another relating to the estate return were sent by the Service upon Mrs. Kite's death. Mrs. Kite died 3 years after the annuities were exchanged for the KIC interests.

As the decision of whether the March 2001 transfers were for full and adequate consideration is entirely dependent on the value of the annuities, that's where the Court turned first. Specifically, was it appropriate for the decedent to have relied on standard mortality and valuation tables to value the annuities, when her health at the time was failing? In reaching the decision that it was reasonable, the Court relied on the *McLendon* decision [135 F3d 1017 [5th Circuit 1998] revising T.C. Memo 1996-307] and the following reasoning:

1. As established in *McLendon*, the party attempting to depart from the tables has the burden of proving such departure is justified.

2. The Regulations provide that the mortality component of the actuarial tables may not be used to determine the present value of an annuity if the taxpayer is terminally ill. And terminal illness is defined as a condition where the resulting chance of death within one year is at least 50 percent.

3. While Mrs. Kite was in declining health as of the transaction date, she was able to get a letter from her physician attesting that he had examined and interviewed her at her home and "would anticipate that her longevity and health outlook is good for the next several years" and that she was "not terminally ill" nor did she have "an incurable illness or other deteriorating physical condition that would cause her to die within one year". The physician estimated that her probability of surviving 18 months or longer was "at least 50%".

4. While Mrs. Kite was receiving home health care beginning in 2001 and was incurring thus substantial medical expenses, the Court notes that the expenses were mostly due to Mrs. Kite's decision to receive health care in her home (her prescription drug expenses, for one thing, were minimal) and that her decision to receive health care at home could simply be explained by her affluence.

5. The Kite children were also affluent, after several rounds of gifts, and could have afforded to pay the annuity, at least for a while, had Mrs. Kite survived the ten-year deferral period. Since Mrs. Kite died before the beneficiaries were obligated to make annuity payments, tax was avoided on approximately $800,000.

6. Mrs. Kite had access to enough other assets that she didn't really need the income flowing from the KIC interests and it was thus reasonable for her to "risk those interests for the potential *profit* in the annuity transaction." The existence of her profit motive is further supported by her "position of independent wealth and sophisticated business acumen."

Based on the foregoing, the Court determined that "Mrs. Kite and her children reasonably expected that she should live through the life expectancy determined by the IRS actuarial tables, which was 12.5 years". It is even more reasonable to conclude that they expected she would not live through her life expectancy, and structured the transaction accordingly. However, the standard is only that she was expected to live more than a year. And since the March 2001 transfer was for full and adequate consideration, the Court also rejected the respondent's argument that the annuity transaction lacked economic substance.

Did the Service make another unforced error here? Did this challenge, by providing such an easy win for the taxpayer, open up a huge new estate planning opportunity for the wealthy ? The Court's decision here provides wide leeway for such transactions going forward. There must be a substantial number of clients for whom life expectancy is more than one year, but where the probability of outliving a set number of years (any number of years) is negligible. Such clients would have the ability to transfer significant amounts with almost no risk of anything being pulled back into their estates after the deferral period is over.

The Court's decision can be found on the U.S. Tax Court's website and at: http://www.NYNJCT-BV.com/KiteMemo.TCM.WPD.pdf

J.L. PIERSON, ASA
Business Valuation
mailto:jlp@NYNJCT-BV.COM
http://www.NYNJCT-BV.COM
(203) 325-2703 Office
(203) 504-7925 Fax
(203) 434-4648 Cell
368 Heights Road # 2392
Darien CT 06820