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# Income Taxation of Exchanges of Property for Private Annuities: History and a Proposal, The

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# The Income Taxation of Exchanges of Property for Private Annuities: History and a Proposal

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A private annuity, for the purposes of this article, is an agreement by an annuity writer, an individual,[1] to make a series of equal payments to the annuitant, another individual, for the life of the annuitant.[2]

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1. Annuities written by charities and other organizations that write annuities from time to time are governed by a somewhat different set of rules. A discussion of these annuities is beyond the scope of this article. Rev. Rul. 62-136, 1962-2 C.B. 12.

2. Middleditch, *Report of the Subcommittee on Private Annuities and Estate Planning*, 102 TR. & EST. 952 (1963). Private annuities can also be written for the life of an annuitant for a term certain greater than the life expectancy of the annuitant, whichever term ends sooner, a private annuity for a term of years or PATY. *See generally* Hartz & Banoff,

Private annuities provide security for the annuitant, because the annuitant cannot outlive the stream of payments.[3] Because of the risk that an annuitant might outlive her life expectancy, however, prospective transferees of the property of an older relative are often unwilling to take on such an obligation.[4] Therefore, private annuities have been an often-discussed but seldom-used estate planning device.[5] Estate planners have used the private annuity, and other techniques, to limit the growth of a client's gross estate, or "freeze" the estate.[6] By exchanging a property that may be increasing in value for an annuity, which will only become less valuable over time, transferors can limit their estate tax liability.[7] Congress has recently enacted legislation to stop estate tax avoidance though the use of estate-freezing techniques.[8] Private annuities may become more popular in light of the 1988 tax revision, however, because they are one of the few estate-freezing techniques that may survive the estate tax provisions enacted to render estate freezes ineffective.[9]

Private annuities hold a certain fascination for tax and estate planning scholars.[10] Because private annuities involve concepts both of

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*Planning Opportunities Available Using Private Annuities for a Term of Years*, 65 J. TAX'N 302 (1986) (discussing the private annuity for a term of years). An annuity written for a period of years shorter than the life expectancy of the annuitant will be treated as an installment sale. Rev. Rul. 86-72, 1986-1 C.B. 253. A discussion of private annuities for a term of years is beyond the scope of this article.

3. Annuitants do, however, take the risk that the annuity writer will be unable to make the payments throughout the annuitant's life. This is one of the principal reasons that some prospective annuitants decide not to enter into private annuity contracts. Ekman, *Private Annuities*, 22 OHIO ST. L.J. 279, 280-81 (1961); *Subcommittee Report*, *supra* note 2, at 959.

4. *Subcommittee Report*, *supra* note 2, at 958.

5. Covey, *Estate, Gift, and Income Taxation, 1969 Developments*, 4 MIAMI INST. ON EST. PLAN. ¶ 70.102.1 (1969).

6. *See generally* Abbin, *The Value-Capping Cafeteria—Selecting the Appropriate Freeze Technique*, 15 INST. ON EST. PLAN. ¶¶ 2000-2015 (1980).

7. *Id.* at ¶ 2001, 2001.2.

8. I.R.C. § 2036(c) (1989). All references to the Internal Revenue Code refer to the Internal Revenue Code of 1986, as amended to September 20, 1989, unless otherwise indicated.

9. *See infra* notes 43-59 and accompanying text.

10. Manning and Hesch, *Private Annuities After the Installment Sales Revision Act of 1980*, 6 REV. OF TAX'N OF INDIVS. 20 (1982) (hereafter Manning & Hesch); Ginsburg, *Future Payment Sales After the 1980 Revision Act*, 39 INST. ON FED. TAX'N §§ 43.01-43.11 (1981) (hereafter Ginsburg, *1980 Revision*); Ginsburg, *Taxing the Sale for Future Payment*, 30 TAX L. REV. 471 (1975) (hereafter, Ginsburg, *Future Payment*); Stewart, *Private Annuities—Revenue Ruling 69-74 Partially Repudiated, Sub Silentio, by Treasury Regulation Section 1.1011-2(c), Example (8)*, 24 MERCER L. REV. 585 (1973); Midgley, *Federal Income Taxation of Private Annuitants*, 40 GEO. WASH. L. REV. 679 (1972); Ross, *The Private Annuity as a Tax Minimizing Instrument*, 41 TAXES 199 (1963); Wallace, *Taxation of Private Annuities*, 40 B.U.L. REV. 349 (1960); Davey, *Property Exchanged for a Promise to Pay an Annuity—Transferee Problems*, 33 TAXES 494 (1955); Meyer, *Transfer of Property for an Annuity—Tax Position of the Transferee*, 31 TAXES 645 (1953); Andro, *Non-Commercial Annuities—Income Tax Conse-*

annuities and of property sales, and because of the indeterminable stream of payments involved, the resolutions of issues like gain recognition and computation of basis are rarely satisfying. Therefore, writers are constantly tempted to criticize the rules formerly in effect and attempt to come to solutions more clearly in line with underlying tax principles.

For income tax purposes, private annuities have proven to be a problem, primarily because the duration of payments to be made to the annuitant is uncertain. Several income tax issues are involved in private annuities. As with annuities purchased for cash, the tax statute must reflect the fact that each payment consists of a return of the principal invested in the annuity and of income earned from that principal. When the annuitant transfers appreciated property to the annuity writer in exchange for the annuity, additional questions arise about when to recognize the gain or loss in the annuitant's transferred property. For the annuity writer, the most important questions are whether any part of the annuity payments can be deducted as interest and how to compute the basis in the acquired property.[11]

The actuarial principles underlying annuities had been established for centuries before enactment of the modern income tax.[12] American income tax statutes before 1954, however, treated annuities with little regard to their economic principles.[13] Even after adopting a more rational scheme for taxing annuities in section 72 of the 1954 Internal Revenue Code,[14] complete conformity with the economic principles of annuities still have not been achieved. The Internal Revenue Service has attempted to establish uniform principles for the taxation of private annuitants[15] and private annuity writers[16] by promulgating comprehensive Revenue Rulings. Amendments to the Internal Revenue Code during the 1980's, however, particularly changes in the treatment of installment sales, annuities, and imputed interest, have cast doubt on the Service's rulings. In addition, development of new estate planning devices, particularly the Death Terminating Installment Sale, economically similar to the private annuity but with different income tax

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*quences to the Transferor Who Exchanges Property in Return for an Annuity*, 9 TAX L. REV. 85 (1953); Galvin, *Income Tax Consequences of Agreements Involving Non-Commercial Annuities*, 29 TEX. L. REV. 469 (1951) (hereafter Galvin).

11. *See Galvin, supra* note 10.
12. *See infra* notes 21-28 and accompanying text.
13. *See infra* notes 60-161 and accompanying text.
14. I.R.C. § 72(a)-(c) (1954). *See also infra* notes 162-182 and accompanying text.
15. Rev. Rul. 69-74, 1969-1 C.B. 43.
16. Rev. Rul. 55-119, 1955-2 C.B. 352.

consequences, require a reconsideration of the income tax consequences of private annuities.

This article will briefly review the history and actuarial principles underlying annuities.[17] It will then review the history of the tax treatment of private annuities and the current state of the law, first for annuitants and then for annuity writers.[18] Finally, this paper will propose a revision of the Internal Revenue Service rulings governing private annuities.[19] This article will concentrate on three issues involved in transfers of appreciated property in exchange for private annuities—the annuitant's gain recognition, the annuity writer's potential interest deduction, and the basis for the annuity writer in the property acquired in exchange for the private annuity.[20] This article will recommend: (1) That the gain inherent in the property transferred by annuitants be recognized ratably over the life expectancy of the annuitant according to the annuity, rather than the installment sales, provisions of the Code; (2) that annuity writers be permitted to treat a portion of each annuity payment as interest; and (3) that, in most cases, annuity writers use the actuarial value of the annuity as their basis in the acquired property.

## I. History and Theory of Annuities

### A. *History of Annuities*

Both the theory and the business practice of writing annuities were well established before the adoption of the modern income tax in 1913. The rudiments of the actuarial principles of annuities were developed in Europe in the seventeenth century.[21] European governments in the seventeenth century arranged government loan repayments

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17. *See infra* notes 29-42 and accompanying text.

18. *See infra* notes 60-284 and accompanying text.

19. *See infra* notes 274-351 and accompanying text.

20. This article will not deal with whether the creation of the private annuity will be treated as retention of the income from the transferred property. *See* Loftis, *When Can a Trust Be Used to Fund a Private Annuity Without Creating a Retained Interest?*, 14 Est. Plan. 218 (1987) and the cases cited therein for a discussion of this problem. This article will also not deal with the application of related party loss or gain rules to private annuities. *See* I.R.C. §§ 267, 1239.

21. 2 Encyclopedia Britannica, *Annuities* 1, 2 (1957). The first reference to the value of an annuity is "the provisions of the Roman *lex Falcidia* of 40 B.C.; but the tables of values were the result of conjecture rather than of statistical investigation, and the element of interest was not taken into account." *Id.*

in the form of annuities. In exchange for lending money to the government, the lender received an annuity. By 1671, the "grand pensionary of Holland and West Friesland worked out the practical rule that, taking interest at four percent, a life annuity to a healthy young person was worth sixteen times its yearly amount."[22] To illustrate, a healthy, young burgher in Holland in the late seventeenth century would lend 1600 guilders to the government and would receive his repayment in the form of an annuity of 100 guilders per year. John Graunt developed the first accurate mortality tables in England in 1662, so that the life expectancy information necessary to value annuities was available.[23] In 1693, Edmund Halley produced another mortality table and, more importantly, demonstrated how the tables could be used to compute the value of annuities.[24] In 1808, the British government began publishing mortality tables, and by 1875, the English actuary, A.J. Finlaison, had determined that annuitants tended to be longer-lived than the general population.[25]

As in many other fields of knowledge and business practice, Americans borrowed British expertise. American life insurance companies issued annuities during the ninteenth century, basing their computations on British tables.[26] An American actuary, Emory McClintock of what is now Mutual of New York, published the first annuity table based on American mortality experience in 1899, and by 1920 many other companies had followed suit.[27] A Pennsylvania Common Pleas judge, writing one year before the adoption of the modern Federal income tax, recognized that "the calculation of an annuity is an extremely intricate mathematical problem. It is a matter of pure science; it is not a question of fact."[28] Therefore, at the time the income tax was enacted, the mathematical formulae necessary to understand and compute annuities had been available for more than two centuries, and the mortality tables reflecting American life expectancies were widely available.

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22. Encyclopedia Britannica, *Annuities* 75-78 (11th ed.), *cited in* Wolf v. Schmidt & Sons Brewing Co., 21 Pa. Dist. Rpts. 164, 166 (1912).
23. Graunt published his findings, based largely on church and local records, in his book NATURAL AND POLITICAL OBSERVATIONS . . . Made upon the Bills of Mortality in 1662. 4 ENCYCLOPEDIA BRITANNICA, *Demography* 6 (1976).
24. 2 ENCYCLOPEDIA BRITANNICA, *Annuities* 1, 2 (1957).
25. *Id.* at 3.
26. 2 ENCYCLOPEDIA BRITANNICA, *Annuities* 1, 4 (1957).
27. *Id.*
28. Wolf v. Schmidt & Sons Brewing Co., 21 Pa. Dist. Rpts. 164, 167 (1912).

### B. Theory of Annuities

Understanding the tax law applicable to annuities is difficult without first understanding the mathematical and demographic basics of annuity computations. The single-life annuity is a stream of payments that will terminate upon the death of the measuring life, usually the life of the annuitant.[29] In a typical annuity transaction, Aunt Anne would pay Really Secure Insurance Company a sum of money in exchange for the company's promise to make periodic payments to Aunt Anne for her life. Really Secure's actuaries must estimate how much Aunt Anne will receive based on mortality statistics, future investment returns, and the company's costs associated with the annuity to know how much to charge Aunt Anne. To understand the complex process of computing the value of a single-life annuity, it is first important to understand the simpler process of computing the value of a stream of payments for a set period.[30] The value of an annuity is the sum of the present values of each of the payments that the annuitant will receive. The value of each payment is the amount that will be paid in the future, discounted by the amount of interest that the payor can earn on the fund until the payment must be made to the annuitant.[31] After deciding the amount to be paid each year and the term of the payments, one need only determine the rate of interest that a deposit will earn to determine the principal amount needed to pay an annuity. Because interest rates fluctuate, the actual interest that the payor may earn is unknown. Instead, to compute the value of an annuity one must make an assumption about what the interest rate will be, and the usual assumption is that the current interest rate will remain in effect for the term of the annuity.[32] In valuing annuities,

29. Johnson, *Special Commentary: Discounting and Compounding with the Addition of Single Life Contingencies—Calculation of the Present Value of an Annuity, Life Estate, Term for Years, Remainder, or Reversion Involving One Life on a Term Certain*, 11 S. ILL. L.J. 315, 316 (1986), (hereafter Johnson, *Special Commentary II*). *See also* R. MEHR & E. CAMMACK, PRINCIPLES OF INSURANCE 538 (4th ed. 1966).

30. The principles in the following discussion of valuing annuities and the order of discussion are based upon Johnson's *Special Commentary*, published in four parts in volumes 11 and 12 of the Southern Illinois Law Journal. The author used the first two parts of the *Special Commentary*. *See supra* note 29 (second part); Johnson, *Special Commentary: Discounting and Compounding—Calculation of the Present Value of an Annuity, Term for Years, Remainder, or Reversion Dependent on a Term Certain*, 11 S. ILL. L.J. 87 (1986) (first part) (hereafter Johnson, *Special Commentary I*).

31. Johnson, *Special Commentary I*, *supra* note 30, at 111.

32. *Id.* at 96.

the Treasury Department prescribes tables based upon an approximation of the interest rates at the time the parties contract for their annuity.[33]

To take a simple example, consider a three-year annuity of $1,000 per year. The three payments are to be made exactly one year, two years, and three years after the parties entered into the transaction. Assuming an 8% rate and annual compounding of interest, the present value of the first year's payment is $925.93, computed by dividing the amount of the payment by one plus the rate of interest, here 1.08.[34] The present value of the second payment, which requires the consideration of compound interest, is $1,000 divided by the square of 1.08 or $857.34. The present value of the third payment, $1,000 divided by the cube of 1.08, is $793.83. The total present value of such an annuity when the contract is entered into is $2,577.10.[35]

In an annuity measured by a life, the value of the annuity is a function of both interest and the life expectancy of the annuitant.[36] Mortality tables are the foundation of life expectancy computation. Ideally, life expectancies would be based on studies of all people born in a year, keeping track of their mortality throughout life. Such studies are not feasible, and so, instead of following one cohort for a lifetime, demographers assume that the current population represents how the various annual cohorts in the current population will survive as they age.[37] Standard mortality tables show the number of people alive at certain ages out of a hypothetical starting population of 100,000 people of the same age. The table cannot be used to predict whether any individual will survive to a given age, but the table can be used to estimate the probability of the individual surviving to a certain age.[38] The cost of an annuity for a person of any age is computed as a weighted average of the cost of providing annuities for an entire population. For each year, payments would have to be made only to the number of people still alive. Also the amount of money that would

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33. *Id.* at 96-99. Johnson finds two problems with the Treasury tables. First, that they reflect nominal, rather than real, rates of return, and second, that the tables have too seldom been adjusted to reflect current rates of return. *Id.* Internal Revenue Code section 7520, adopted in 1988, requires the Treasury Dept. to adjust such tables monthly to reflect current mortality experience and interest rates.

34. Johnson, *Special Commentary I*, *supra* note 30, at 107.

35. *See* Johnson, *Special Commentary II*, *supra* note 29, at 328.

36. Johnson, *Special Commentary I*, *supra* note 30, at 96, *citing* L. Wolfe & W. Corcoran, Inheritance Tax Calculations 7 (1937).

37. Johnson, *Special Commentary II*, *supra* note 29, at 318-19.

38. *Id.* at 319.

be deposited now to provide such annuities would be the present value, taking account of the amount of interest that would be earned by the deposit between the date of deposit and the date of payment. Therefore, for each year of the annuity, the amount to be paid would be the amount of the payment multiplied by a fraction that takes account of both life expectancy and the time value of money.[39]

Assume that on January 1, 1991, we wish to put aside a sum to provide for a payment of $1 each to 100,000 people, aged forty, that would survive for one year, until January 1, 1992. To take account of the number of people who die during 1991, we would divide the number of people expected to survive until January 1, 1992, $lx_1$, by the total number of people in our original population of forty-year-olds, $lx$. To take account of the time value of money, we would multiply our fraction by a discount factor reflecting the time value of money, V. Our final formula, for an annuity paid for just one year would be $lx_1 \, V/lx$. Computing the total cost of a life annuity for our population requires us to add up the cost of each year's annuity for all future years until the mortality table informs us that our population will have died out. The formula would be as follows:

$lx_1 \, V/lx + lx_2 \, V^2/lx + lx_3 \, V^3/lx + \ldots + lx_n \, V^n/lx$, or

$lx_1 \, V + lx_2 \, V^2 + lx_3 \, V^3 + \ldots + lx_n \, V^n \, lx$ (where n equals the last age).[40]

Annuity tables, such as the old valuation table for annuities in the estate tax regulations,[41] provide simple decimal fractions for each age that can be multiplied by the annual annuity payments to complete the value of an annuity. The authors of the tables apply the formula above, beginning with the current age of a cohort of annuitants, to

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39. *Id.* at 328-332.

40. *Id.* at 329-330. These computations approximate what an insurance company might do in accumulating an annuity fund and paying out to a group of customers. In a large population, the company's mortality gains from short-lived annuitants would tend to offset the losses from annuitants who outlived their expectancies. In private annuities between individuals, however, mortality gains or losses without any offset affect the resources of the annuity writer. One would expect parties entering into a private annuity for an estate planning purpose to have consulted a knowledgeable adviser. The predictions of annuity tables, however, are often secondary to other considerations in private annuities. If the parties are only concerned about the investment return and security in the transaction, they probably would use a commercial annuity. Galvin, *Income Tax Consequences of Agreements Involving Noncommercial Annuities*, 29 TEX. L. REV. 469, 479 (1951). On this point, Galvin quotes Steinbach Kresge Co. v. Sturgess, 33 F.Supp. 897, 900 (D.N.J. 1940), as follows: "The fact is that the annuitant deliberately forsook the insurance market and established his own. Actuarial values per se have, therefore, no logical bearing upon the value of a noncommercial annuity contract issued in return for property." *Id.*

41. Treas. Reg. § 20.2032-7, Table A, T.D. 7955, 1984-1 C.B. 40, 81.

compute the decimal fraction for each age.[42] With some understanding of the theory of annuities, it is now possible to explore the use of private annuities in estate planning.

### *C. The Use of Private Annuities in Estate Planning*

The private annuity is an estate-freezing device[43] that enables older persons to replace appreciated property in their estates with an asset that disappears at death. In a typical private annuity transaction, for example, Aunt Anne would like to transfer property that has increased in value since Anne acquired it to a relative. Anne would also like to provide for a steady income to help to support her in her declining years. Aunt Anne, the annuitant, achieves her aims by trading her appreciated property to her niece, Nettie, the annuity writer, for a stream of payments ending at Aunt Anne's death. Aunt Anne loves the security of the annuity, but she may find it difficult to convince Nettie to assume the obligation to make payments for the rest of Aunt Anne's life, because of the risk that Anne might outlive her life expectancy.[44]

The federal estate and gift tax consequences of such transactions, before the enactment of recent legislation to limit estate freezing techniques,[45] were fairly well settled. The annuity would be valued according to tables published by the Department of the Treasury.[46] The transferor was not treated as making a gift unless the value of the property transferred exceeded the value of the annuity. If so, then the difference was treated as a gift from Aunt Anne to Nettie for gift tax purposes.[47] Because the obligation to make payments

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42. Johnson, *Special Commentary II*, *supra* note 29, at 330-333. The former valuation tables have become obsolete. In response to Internal Revenue Code section 7520(c)(3), enacted by section 5031 of TAMRA of 1988, Pub. L. 100-467, 102 Stat. 3342 (1988), which requires the Treasury Department to promulgate new valuation tables reflecting current interest and current mortality experience, the Internal Revenue Service has promulgated Notice 89-60, 1989-22 I.R.B. 16, which provides mathematical factors only for remainder interests. Taxpayers and their advisers now must compute their own annuity factors according to instructions given in Notice 89-24, 1989-10 I.R.B. 16. *Id.*

43. Abbin, *Value Capping Cafeteria, Selecting the Appropriate Freeze Technique*, 15 MIAMI EST. PLAN. INST. ¶¶ 2000-2015 (1981).

44. *Subcommittee Report*, *supra* note 4, at 958.

45. I.R.C. § 2036(c) (1989).

46. Rev. Rul. 69-74, 1969-1 C.B. 43, 44 (hereafter Rev. Rul. 69-74). Rev. Rul. 80-80, 1980-1 C.B. 194 requires the use of the Treasury Department tables unless the annuitant's death is "imminent" at the time the annuity was written. *Id.* at 195.

47. Rev. Rul. 69-74 at 44.

disappeared at the death of the annuitant, absent section 2036(c),[48] the annuity escaped the decedent's gross estate.[49] The private annuity transaction may even avoid estate taxation under newly revised section 2036(c), if properly planned.[50]

Congress enacted section 2036(c) in 1987,[51] and revised it in 1988,[52] to prevent taxpayers from using recapitalizations and similar "estate freezing" techniques to avoid the estate tax.[53] An illustration of an estate-freezing recapitalization may help the reader to understand section 2036(c). Aunt Anne, the transferor, is owner of 100% of the common stock of Growing Corp. In the recapitalization, she would exchange her common stock for voting preferred stock (limited and preferred as to dividends and on liquidation, but having voting control of the corporation). Anne would also receive common stock that is less than 50% of the voting control, and Anne would transfer the common stock to her niece, Nettie. At the time of the recapitalization and gift of the common stock to Nettie, the value of the preferred stock would approximately equal the value of the corporation before the recapitalization. Therefore, the value of the gift to Nettie is negligible. As the value of Growing Corp. increases, how-

48. I.R.C. § 2036(c).

49. I.R.C. §§ 2033, 2036 (1986). For a more thorough discussion of the estate tax consequences of private annuities, *see* Bilansky, *Making the Most of Private Annuity Arrangements to Transfer Property and Reduce Estate Tax*, 8 EST. PLAN. 102 (1981).

50. The key to avoiding section 2036(c) is meeting the "substantial consideration" rule of section 2036(c)(2)(B), an exception to the general rule of section 2036(c)(1). The decedent's estate must establish that the family member who wrote the annuity provided full consideration "in money or money's worth" for the property received and establishes that the annuity writer paid with the writer's own money, rather than income from the transferred property or other funds originally provided by the annuitant. I.R.C. § 2036(c)(2)(B)(i)(I) (1989). Those planning the transaction must be able to establish "to the satisfaction of the Secretary" that the "consideration originally belonged to such member and was never received or acquired (directly or indirectly) by such member from the transferor for less than full and adequate consideration in money or money's worth." I.R.C. § 2036(c)(2)(B)(i)(II) (1989). *See* Blattmachr & Gans, *An Analysis of the TAMRA Changes to the Valuation Freeze Rules: Part II*, 70 J. TAX'N 74 (1989).

51. I.R.C. § 1042(b), Pub. L. 100-203 (1987).

52. I.R.C. § 3031, Pub. L. 100-647 (1988). The general rule of the legislation to prevent estate freezes, paragraph (1) of section 2036(c), reads as follows:

> (c) Inclusion Related to Valuation Freezes.—
> (1) In general—For purposes of subsection (a), if—
> (A) any person holds a substantial interest in an enterprise, and
> (B) such person in effect transfers, after December 17, 1987, property having a disproportionately large share of the potential appreciation in such person's interest in the enterprise while retaining an interest in the income of, or rights in, the enterprise, then the retention of the retained interest shall be considered to be a retention of the enjoyment of the transferred property.

*Id.*

53. H.R. REP. No. 391, 100th Cong., 1st Sess. 1042-1044 (1987).

ever, the value of the preferred stock remains frozen, while the value of the common stock increases. By the time of Anne's death, Nettie may own much of the value of Growing Corp. even though little or no transfer tax was paid on the transfer of wealth.[54] Section 2036(c) treats Anne's retention of such a frozen interest as though she had retained the income from the common stock transferred to Nettie, and under section 2036(a), if Anne transfers property to someone else and retains the income from the transferred property, the property must be included in Anne's gross estate at her death.[55]

Because a private annuity replaces property that may appreciate with a contract that gives an income stream to the annuitant and that will gradually decline in value over the life span of the annuitant, a private annuity probably comes within the scope of section 2036(c).[56] Private annuities differ from recapitalization transactions and some other estate-freezing transactions in that the private annuity is a sale for full consideration, if the actuarial value of the annuity equals the value of transferred property.[57] Reflecting Congress' abundance of caution, section 2036(c) requires not only that intra-family sales have full consideration, but also that transferees use their own money to make the purchase, rather than using funds that originally came from the "estate-freezing" transferor.[58] While the application of the consideration rules of section 2036(c) to private annuities is not yet clear, it seems that using private annuities to avoid section 2036(c) will depend on the annuity writer using her own money to make the annuity payments rather than funds from the property transferred in exchange for the annuity.[59] Having in mind the history, theory, and estate tax consequences of annuities establishes the background necessary to explore the long and confusing history of the income tax consequences of both the simple commercial annuity and the more complex private annuity.

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54. Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COL. L. REV. 161, 170-177 (1977).
55. I.R.C. § 2036(c).
56. Notice 89-99, 1989-38 I.R.B. 4, 5.
57. Rev. Rul. 69-74, 1969-1 C.B. 42.
58. I.R.C. § 2036(c)(2).
59. *Id. See also* Blattmachr & Gans, *An Analysis of the TAMRA Changes to the Valuation Freeze Rules: Part I*, 70 J. TAX'N 14 (1989); Blattmachr & Gans, *An Analysis of the TAMRA Changes to the Valuation Freeze Rule: Part II*, 70 J. TAX'N 74 (1989). *See also* Notice 89-99, 1989-38 I.R.B. 4, particularly example 24 at 41 & 53. Commentators express considerable dissatisfaction with the present form of section 2036(c), and the section may be subject to further amendment or repeal. Louden, *Treasury Rejects Proposals to Retroactively Repeal Estate Freeze Limits*, 43 TAX NOTES 926 (1989).

## II. Federal Taxation of Annuitants Before 1954

### A. Treatment of Annuities Before the 1934 Act

Until the 1950's, the federal income tax treatment of the annuity lagged decades behind actuarial science and the commercial treatment of annuities. The science of annuities did not find a place in the simple, early federal income tax, and Congress' first attempt, in 1934, to recognize that each annuity payment consisted of both principal and income was a clumsy failure. The only mention of the taxation of annuitants in the 1913 income tax law provided that payees of life insurance and annuity contracts would receive the amounts paid into the policies tax-free.[60]

It was easy to apply the 1913 Revenue Act's language to the case of a cashed-in life insurance policy. If the owner of a life insurance policy received $15,000 upon cashing in the policy and had paid $10,000 in premiums under the policy, the owner had to report $5,000 of gross income. The application of this scheme to annuity policies was less obvious. In 1914, income tax regulations construing the language of the 1913 Revenue Act, required annuitants to treat a portion of each payment as return of capital and the rest as income.[61] The approach of the 1914 regulations approximated the results required by actuarial science and would have produced results similar to those obtained under current annuity rules.[62]

By 1915, however, the regulations and rulings construing the same statutory language adopted a capital recovery approach. The capital

60. Revenue Act of 1913 section II(B), ch. 16, 38 Stat. 114, 167 (1913), provided as follows: "payments made by or credited to the insured, on life insurance, endowment, or annuity contracts, upon the return thereof to the insured at the maturity of the term mentioned in the contract, or upon surrender of contract, shall not be included as income." Similar language appears in section 4 of the Revenue Act of 1916, section 1200 of the Revenue Act of 1917, section 213(b)(2) Revenue Acts of 1918, 1921, 1924, and 1926, and section 22(b)(2) of the Revenue Acts of 1928 and 1932. For amendments in the 1926 Act to clarify the meaning of the stated language, see *infra* note 73 and accompanying text. Permitting taxpayers to recover their investment tax-free was contrary to the British approach, which treated the entire annuity payment as income. Magill, *The Income Tax Liability of Annuities and Similar Periodical Payments,* 33 YALE L.J. 229, 234-35 (1924).

61. T.D. 2090, 16 Treas. Dec. Int. Rev. 259, 260 (1914), *cited in* Meisenholder, *Taxation of Annuity Contracts under Federal Income Tax,* 40 MICH. L. REV. 1005, 1007 n.8 (1942).

62. *See* I.R.C. § 72.

recovery approach permitted the annuitant to receive payments tax-free until the annuitant's investment in the contract had been completely recovered. The taxpayer then included in income all payments received after the invested capital of the taxpayer had been recovered.[63] *Warner v. Walsh*,[64] possibly the first litigated private annuity income tax case, followed the recovery of capital approach used by most of the earlier rulings.[65] In *Warner v. Walsh*, Mrs. Warner exchanged her statutory rights in her husband's estate for an annuity to be paid by a trust created under the will of her late husband.[66] The court treated the value of her statutory rights as the principal paid for the annuity and allowed her to exclude the annuity payments from income until she had recovered the value of her statutory rights.[67] Most early cases followed the capital recovery approach used in *Warner v. Walsh*.[68]

However, the Board of Tax Appeals adopted a completely different approach in *Klein v. Commissioner* based upon the actuarial principles underlying annuities.[69] *Klein* resulted from a dispute over an inheritance. The taxpayer, a daughter of the decedent, agreed to give up her claim against the estate and other heirs in exchange for an annuity of $5,000 per year. The court valued the annuity at $57,753.50. The court then determined that, while the statutory language required that the taxpayer receive her investment in the contract tax-free, it did not require that each payment be completely tax-free until the annuitant had recovered her investment basis. Instead, the court required the taxpayer to report each payment to be apportioned between income and principal, intending the allocation between principal and income reflect the "normal theory of purchased annuities."[70] The Internal Revenue Service acquiesced in the *Klein*

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63. T.D. 2152, 17 Treas. Dec. Int. Rev. 95, 96 (1915), *cited in* Meisenholder, *Taxation of Annuity Contracts under Federal Income Tax*, 40 MICH. L. REV. 1005, 1007 n.8 (1942). Most early income tax rulings reflect the return of capital approach. *E.g.*, O.D. 170, 1 C.B. 298 (1919); T.D. 3112, 4 C.B. 1403. In at least one ruling, however, the pro rata recovery approach was used. O.D. 1108, 5 C.B. 92 (1921), *cited in* Meisenholder, *supra* at 1007 n.8.

64. 15 F.2d 367 (2d Cir. 1926), (construing the 1917 and 1918 Revenue Acts).

65. *E.g.*, I.T. 1484, I-2 C.B. 66 (1922).

66. Warner v. Walsh, 15 F.2d at 368.

67. *Id.* at 368.

68. *See, e.g.*, United States v. Bolster, 26 F.2d 760 (1st Cir. 1928); Allen v. Brandeis, 29 F.2d 363 (8th Cir. 1928); Continental Ill. Bank & Trust v. Blair, 45 F.2d 345 (7th Cir. 1930). *But see*, Klein v. Commissioner, 6 B.T.A. 617 (1927).

69. Klein v. Commissioner, 6 B.T.A. 617 (1927). The Klein case involved the same language, in the 1916 and 1918 Revenue Acts, construed in *Warner v. Walsh*.

70. Klein v. Commissioner, 6 B.T.A. at 622. An annuity contract may be viewed as a stream of payments liquidating the amount originally invested in the contract. The investment

decision,[71] and while there was some dispute about the mathematics employed in the *Klein* case, other courts followed the *Klein* or "actuarial" approach.[72]

The *Klein* decision, decided in 1927, is particularly interesting when contrasted with the new provision governing the income tax rules applicable to life insurance and annuities in the Revenue Act of 1926. Congress amended the life insurance and annuity rules in 1926 to remove any possible doubt that the taxpayer must recover all consideration paid for the contract before receiving any income. Section 213(b)(2) of the Revenue Act of 1926 listed as amounts excluded from gross income:

> Amounts received . . . under a[n] . . . annuity contract, but if such amounts (when added to amounts received before the taxable year under such contract) exceed the aggregate premiums or consideration

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earns interest, but the amount of the payment requires that some principal, as well as the interest, be paid even in the first year of the contract. As the principal is paid out, the amount of interest that the remaining principal can earn is smaller for each payment, requiring the amount of principal in each payment to increase as the annuity payments continue. *Galvin*, *supra* note 10, at 480. Under this "actuarial" approach to taxing the income, annuitants are treated as receiving a large amount of income in the first payment, with a small amount of the first payment excluded as principal. Each succeeding payment includes less income and has a larger exclusion. Using the three-year annuity at 8% annual interest discussed in the example following note 33, the annuitant paid $2,577.10 for an annuity of $1,000 per year. The investment will earn $206.17 of interest the first year, and the remainder of the first $1,000 payment, $793.83, is principal. The principal remaining at the beginning of the second year, $1,783.27, is computed by subtracting the $793.83 paid out in the first annuity payment from the $2,577.10 original principal. The second year's payment consists of $142.66 interest (8% interest on $1,783.27), and $857.34 of principal. After the second annuity payment, $925.93 of principal remains ($1,783.27 - $857.34) and earns $74.07 of interest. The final payment consists of the $925.93 principal and $74.07 interest. Under the "actuarial" approach recommended in the *Klein* case, the taxpayer would have $206.17 of gross income in year one, $142.66 of gross income in year two and $74.07 of income in year three. Under the "capital recovery" approach of *Warner*, the taxpayer would have no income in years one or two and would have $422.90 of gross income in year three.

71. VII-2 C.B. 17.

72. *E.g.*, Guaranty Trust Co. v. Commissioner, 15 B.T.A. 20 (1929). In *Guaranty Trust Co.*, the decedent had exchanged property for an annuity issued by the bank. The dispute arose after the year of the exchange. The board stated that it would have treated the transaction as a sale in the year of the exchange, followed by a purchase of the annuity. Because only the years after the year of the exchange were at stake, the court treated part of each payment as ordinary income and the rest as a return of the taxpayer's investment, the fair market value of the property traded for the annuity. *Id.* at 24-25.

The difference in opinion over the exact computation of return of principal and interest arose in *Commissioner v. John C. Moore Corp.*, 42 F.2d 186 (2d Cir. 1930). The *John C. Moore Corp.* case involved an annuity writer rather than an annuitant, but the computational issues were the same. The board in *Klein* had required that each payment be discounted back to the date of purchase, while the Second Circuit in *John C. Moore Corp.* described a method of computing the interest based on the remaining unrecovered principal and treated the remainder of the payment as interest. *John C. Moore Corp.*, 42 F.2d at 189. The Second Circuit wrote that this method, rather than that of *Klein*, would "more nearly approach that employed by insurance companies in their annuity calculations." *Id.*

> paid (whether or not paid during the taxable year) then the excess shall be included in gross income.[73]

After the passage of the 1926 Revenue Act, it was clear that the annuitant should report annuity payments by recovering the entire cost of the annuity before reporting any income. Any approach that correctly reflected the actuarial science underlying annuities by treating part of each payment as income and part as principal was rejected.

### B. *Exchanges of Appreciated Property for Annuities*

An exchange of appreciated property for a private annuity required consideration of a different question, namely, how and when should the gain in the appreciated property be recognized? The Board of Tax Appeals decided the leading case involving an exchange of property for a private annuity, *Lloyd v. Commissioner*,[74] after the 1926 Revenue Act provisions were in effect. Unlike most of the previous cases involving an exchange of property for an annuity, the issue was how the gain in the property exchanged for the annuity should be treated. *Lloyd* involved a sale of stock in 1930 from J. Darsie Lloyd to his son, Harold Lloyd, the movie star, in exchange for an annuity.

In a deferred payment sale like a private annuity, to which installment sale treatment did not apply,[75] a taxpayer could either characterize the sale as a closed transaction or as an open transaction. In most cases, taxpayers had to use the characterization of a closed transaction. Closed transaction treatment required the taxpayer to report all of the gain from the transaction immediately. The taxpayer had to compute the entire value of the consideration received, the

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73. Revenue Act of 1926, § 213(b)(2), ch. 27, 44 Stat. 9 (1926). The rationale of the *Klein* case was also undermined by a later case brought by one of her sisters, Cora Louis. After Rosalinda Klein, mother of both the taxpayer in *Klein* and Mrs. Louis, died prematurely, Mrs. Louis attempted to deduct a loss for the amount of the basis in her annuity that she had not recovered. The board, reasoning that annuities were streams of payments that could be valued, allowed a deduction for the unrecovered basis. Louis v. Commissioner, 29 B.T.A. 1200 (1934). On appeal, the circuit court, however, relied on the 1926 amendments to the Revenue Act to require that a recovery of capital approach be applied to annuities. Using a recovery of capital approach, Louis had received total payments in excess of the cost of her annuity, and therefore was not entitled to a deduction. Helvering v. Louis, 77 F.2d 386 (D.C. Cir. 1935).

74. 33 B.T.A. 903 (1936), *nonacq.* XV-2 C.B. 39 (1936), *nonacq. withdrawn and acq.* 1950-2 C.B. 3.

75. *See infra* note 247 and accompanying text.

amount realized,[76] and subtract the adjusted basis of the property from the amount realized to find the gain.[77] The entire gain would be reported in the year of the exchange. In unusual cases in which the uncertain value of the consideration received made it impossible to value the amount realized, however, the taxpayer could use open transaction treatment, reporting gain from the transaction only when the payments received exceeded the adjusted basis of the property sold in the deferred payment sale.[78] In *Lloyd*, the Board of Tax Appeals found that the uncertainties inherent in the transaction required that the annuitant treat the payments as an open transaction under *Burnet v. Logan*.[79] There were two major sources of uncertainty in *Lloyd*, the annuitant's uncertain life span and the risk that the annuity writer would be unable to make all the payments. The Board relied primarily on the annuity writer's potential inability to pay. The Board particularly contrasted the ability to value an annuity granted by an insurance company, with large resources and with its investment practices regulated by law, against that of an individual, with the freedom to make risky investments that could lead to insolvency.[80] A later case determined that the gain from exchanging appreciated property for a private annuity was ordinary income.[81]

Even though the Board did not rely on the annuity rules, its treatment of the gain in the *Lloyd* transaction was consistent with the income tax consequences of annuities. The Code provisions applicable to an ordinary annuity permitted the annuitant to treat the payments, in effect, as an open transaction.[82] The annuitant treated the annuity payments as a tax-free return of capital until the annuitant recovered the cost of the annuity. After the annuitant recovered the cost of the annuity, all subsequent payments under the annuity contract were ordinary income.[83]

A ruling issued by the Internal Revenue Service before the *Lloyd* case was decided shows just how important the uncertainties surrounding the annuity writer's ability to pay could be. In *Gen. Couns.*

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76. *See* I.R.C. § 1001(b).
77. *See* I.R.C. § 1001(a).
78. Burnet v. Logan, 283 U.S. 404 (1931). For a more complete explanation of open transaction treatment, see Ginsburg, *Future Payment*, *supra* note 10, at 559-562.
79. *Lloyd*, 33 B.T.A. at 905.
80. *Id.*
81. Ware v. Commissioner, 159 F.2d 542 (5th Cir. 1947). *See* Ross, *The Private Annuity as a Tax Minimizing Instrument*, 41 TAXES 199, 207 (1973).
82. R. MONTGOMERY, FEDERAL INCOME TAX HANDBOOK 1935-1936 62 (1935).
83. *See supra* note 81 and accompanying text.

*Mem. 1002*,[84] the taxpayer transferred an apartment building to a corporation for a single-life annuity of $12x per year, to be paid in monthly installments. The Bureau of Internal Revenue ruled that the transaction should be closed and that all gain be taxed in the year that the corporation issued the annuity. The Service ruled that the annuity should be valued using tables in the regulations. The value of the annuity would be treated as the amount realized, and the difference between the amount realized and the adjusted basis should be recognized as gain in the year the annuity was issued.[85] The taxpayer could then treat the present value of the annuity at the time of the exchange as the principal sum to be recovered tax-free under the annuity rules. After the principal sum had been recovered in full, the taxpayer would have ordinary income from all subsequent payments.[86] In contrast, the courts came to assume that no private annuity written by an individual had an ascertainable fair market value, thus requiring open transaction treatment.[87]

*Gen. Couns. Mem. 1002* was also important for another reason. Unlike the *Lloyd* case and most other annuity cases, it recognized that a private annuity exchanged for appreciated property involved two distinct sources of income for the annuitant, (1) the gain in the appreciated property, and (2), the interest element common to annuities.

While the tax consequences for annuitants were generally favorable for those who outlived their life expectancies and those who transferred appreciated property in exchange for annuities, it was generally unfavorable for those suffering economic or mortality losses. Annuitants who purchased annuities and who failed to live out their life expectancies could not deduct as losses the amount of their unrecovered premiums.[88] The courts relied on several approaches in denying losses to disadvantaged annuitants. First, the courts held that, because an annuitant had received the security of continuing payments, the annuitant suffered no loss if the payments terminated prematurely.[89] Second, most courts would not admit that a loss had occurred until the payments had ended, and the court could compare

84. Gen. Couns. Mem. 1002, VI-1 C.B. 12 (1927).
85. *Id.*
86. *Id.*
87. Commissioner v. Kann's Estate, 174 F.2d 357 (3d Cir. 1949), *cited in* Ross, *The Private Annuity as a Tax Minimizing Instrument*, 41 TAXES 199, 205 n.32 (1963).
88. Industrial Trust Co. v. Broderick, 94 F.2d 927 (1st Cir. 1938).
89. *Id.*

the total payments received to the basis of the property given up.[90] Third, the courts denied the loss deduction because the transaction was not entered into for profit.[91] Finally, the use of the recovery of capital approach to taxing annuities had the effect of accelerating the taxpayer's recovery of basis. The sooner the basis was recovered, the less likely the taxpayer was to have a loss and the smaller that loss was likely to be.[92]

### C. *Treatment of Annuities After the 1934 Reform*

Another revision of the statutory treatment of annuities in 1934 had the effect of requiring courts to make a more complete analysis of private annuities. The 1934 Revenue Act for the first time set forth a specific rule for taxing only annuities, and the rules were aimed at reducing the perceived tax benefits of annuities. Before the 1934 revision, only annuitants who lived long enough to recover all of the capital invested in the annuity had income. Although annuitants who died before receiving all of their capital back received no deduction, they also had no income.[93] Congress found that the former provisions had been abused. High income taxpayers had used the return of capital approach to taxing annuities to defer substantial amounts of tax.[94] Because of the tax avoidance possibilities, and

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90. Helvering v. Louis, 77 F.2d 386 (D.C. Cir. 1935); Deering v. Commissioner, 40 B.T.A. 984 (1939); Hommel v. Commissioner, 7 T.C. 992 (1946).

91. Industrial Trust Co. v. Broderick, 94 F.2d 927 (1st Cir. 1938).

92. Helvering v. Louis, 77 F.2d 386 (D.C. Cir. 1935). Mrs. Louis had computed her income or loss by treating each payment as consisting of partly a return of capital and partly income. Louis v. Commissioner, 29 B.T.A. 1200 (1934). This was consistent with the tax treatment required of her sister by *Klein* and was upheld by the Board. (*See supra* note 69 for discussion of *Klein*). On appeal, the Court of Appeals reversed, holding that the proper method for recovering principal was to recover all of the principal before having to report any income. Because Mrs. Louis had already received payments in excess of her basis, she had no loss. Helvering v. Louis, 77 F.2d at 388.

93. *Revenue Act of 1934: Hearings on H.R. 7835 Before the Senate Comm. on Finance*, 73d Cong., 2d Sess. 123 (1934) (statement of Byron K. Elliott, Manager and General Counsel, American Life Convention).

94. 78 CONG. REC. 5911 (1934) (comments of Sen. Reed). The Senator posed the example of a rich taxpayer who invests one million dollars in an annuity. Reed explained that "[M]any rich men, with their fortunes in cash form, or easily convertible into cash, have resorted to [annuities], because, obviously, not until 10, 15, or perhaps 20 years after the transaction was entered into would they begin to pay income tax; and when they did, it would be treated as a capital gain, I take it, and they would be taxed at a reduced rate on the theory that they had made this capital investment years before and were now realizing a capital gain from the subsequent payments." *Id.*

because taxpayers seemed to be investing larger amounts of money in annuities,[95] Congress changed the annuity rules to prevent income taxes from being "postponed indefinitely."[96]

The 1934 Act required annuitants to include in each year's gross income three percent of the total consideration paid for an annuity.[97] The 1934 rules treated the remainder of each year's annuity payment as a tax-free return of capital until the consideration paid for the annuity had been recovered tax-free.[98] When the annuitant had excluded the entire amount of the consideration paid for the annuity from gross income, the entire annuity payment became taxable.[99] The congressional drafters intended the "three percent" ordinary income portion of each payment to approximate the return that an annuitant might receive over a normal lifetime on the investment in the annuity.[100]

While the "three-percent rule" recognized that annuity payments consisted of both interest and return of principal, the rules still varied widely from the economic realities of annuities. The choice of an "arbitrary" percentage was, of course, bound to be inaccurate in many cases.[101] Even if the three-percent return figure established at the enactment of the legislation was accurate,[102] the fixed percentage was doomed to become inaccurate as time and investment rates inevitably changed. Also, any system that provides for a constant sum of interest and a constant sum of principal in each payment ignores the realities of present value. The principal sum on deposit is larger in the early years and earns more interest to be paid out, while in later years, the amount of interest paid out is smaller and the amount of principal is larger.[103]

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95. H.R. REP. No. 704, 73d Cong., 2d Sess. 21 (1934). Industry representatives argued, among other things, that an average annuitant received only very small amounts, $430 per year, and that the revenue losses were not so great as perceived by Congress. *Revenue Act of 1934: Hearings on H.R. 7835 Before the Senate Comm. on Finance*, 73d Cong., 2d Sess. 122 (1934) (Brief of Henry Moir, President of the U. S. Life Ins. Co.).

96. H.R. Rep. No. 704, 73d Cong., 2d Sess. 21 (1934).

97. Revenue Act of 1934, ch. 277 § 22(b)(2), 48 Stat. 680, 687 (1934).

98. *Id.*

99. *Id.*

100. H.R. REP. No. 704, 73d Cong., 2d Sess. 21 (1934).

101. *Id.*

102. At least one commentator claimed that the real rate of return on most annuities was only 1 1/2% and that Congress was, in effect, unconstitutionally taxing capital rather than income. Note, *Income Tax on Annuities*, 11 TEMP. L.Q. 567, 568-9 (1937).

103. *Hearings on the Revenue Act of 1934 Before the Senate Comm. on Finance*, 73d Cong., 2d. Sess. 117 (1934) (Brief of Roger B. Hull, for the Nat. Ass'n of Life Underwriters).

*D. Exchanges of Property for Annuities—1934 Act*

Application of the provisions of the 1934 Revenue Act to the exchange of property for a private annuity required the taxpayers to differentiate return of basis, gain from capital appreciation, and ordinary income under the new three-percent rule. No previous case or administrative pronouncement had required such a complex or complete treatment of the private annuity transaction. The early cases only dealt with the application of the three-percent factor.[104] The decisions consistently required the annuity contracts to be valued according to insurance company annuity tables, because the taxpayers had often made disguised gifts in purchasing private annuities from charities or related parties.[105] The three-percent factor was then multiplied by the actuarial value of the annuity contracts to find the ordinary income element.[106]

The first case to deal with the complete problem of ordinary income, return of basis, and gain was *Hill's Estate v. Maloney*,[107] decided in 1944. The unfortunate solution reached by the court required double taxation of the annuity payments.[108] In *Hill's Estate*, the annuitant sold a large block of stock in the corporation he had founded to a syndicate composed of two of his sons and three other trusted employees of the corporation. The syndicate members paid for the stock with both cash and a non-refundable, single-life annuity. In deciding how the gain in the stock should be recognized, the court applied the open transaction rule to the annuity, following *Lloyd* and its progeny. Under the open transaction method, the annuitant would recover his basis fully before having to pay tax on the appreciation in the stock he had transferred.[109] The court then applied the new three-percent rule to the transaction to allocate between the "interest" portion of each annuity payment and the "principal" portion. For this purpose, the court viewed the transaction as though

104. Kann's Estate v. Commissioner, 1947 P-H T.C. Memo. ¶ 47,226, *aff'd* 174 F.2d 357 (3rd Cir. 1948); Gillespie v. Commissioner, 43 B.T.A. 399 (1941), *acq.* 1941-1 C.B. 5, *aff'd* 114 F.2d 140 (7th Cir. 1940); Raymond v. Commissioner, 40 B.T.A. 244 (1939), *acq.* 1939-2 C.B. 31, *aff'd.* 114 F.2d 140 (7th Cir. 1940); Steenburg v. Commissioner, P-H B.T.A. Memo. ¶ 41,184.
105. Raymond v. Commissioner, 40 B.T.A. 244 (1939).
106. *Id.*
107. 58 F. Supp. 164, 175 (D.N.J. 1944).
108. *Galvin, supra* note 10, at 490-491.
109. Hill's Estate v. Maloney, 58 F. Supp. 164, 171-172.

the taxpayer had sold his stock and then purchased an annuity. If the taxpayer had sold the property and then purchased an annuity, two gains would have been recognized, one on the sale and another on receipt of the annuity payments.[110] Therefore, the court determined that three percent of the consideration paid for the annuities should be treated as gross income in each taxable year. In applying both the principles of the *Lloyd* case and the three-percent rule to the facts of the case, however, the court made its mistake. The court reduced Mr. Hill's basis by the entire amount of each annuity payment, including the amount included in income under the three-percent rule. Instead, the court should have subtracted the three-percent "interest" component from each payment first. After the "principal" element of each payment had thus been determined, the court should have reduced Mr. Hill's basis in his stock only by the "principal" portion of each payment.[111] The court also erred by treating both sorts of income as capital gain.[112]

The Internal Revenue Service finally reconciled how the "three-percent rule" and open transaction treatment should be applied to a private annuity. *Revenue Ruling 239*[113] described a familiar private annuity transaction. The annuitant exchanged real estate with a fair market value of $40,000 and an adjusted basis of $5,600 for a private annuity of $2,000 per year. The Service first applied the three-percent rule to the fair market value of the consideration paid for the annuity, the $40,000 real estate, to produce $1,200 of ordinary income, the interest element, in each year's payment. The Service then treated the remaining $800 in each payment as principal under the *Lloyd* case. The taxpayer would be able to treat the $800 per year as tax-free return of principal for seven years until the adjusted basis of the property was recovered tax-free, and as capital gain until the $40,000 fair market value of the real estate was recovered in fifty years. After that, each annuity payment would be ordinary income.[114]

The annuity provisions enacted by the 1934 Revenue Act, unlike previous statutory provisions, recognized, albeit clumsily, that each annuity payment consisted of both income and the return of the annuitant's investment. The *Lloyd* case had held that the gain in appreciated property exchanged for a private annuity should be

110. *Id.* at 174.
111. *Galvin, supra* note 10, at 490-491.
112. Hill's Estate v. Maloney, 58 F. Supp. 164, 178-79.
113. Rev. Rul. 239, 1953-2 C.B. 53.
114. *Id.*

treated as an open transaction because of the uncertain ability of an individual annuity writer to make the annuity payments. Reconciling these principles proved difficult, but in 1953, *Revenue Ruling 239* provided a comprehensive scheme for combining the rules of the *Lloyd* case and the three-percent rule for taxing annuitants in private annuity transactions.

## III. Treatment of Annuity Writers Before the 1954 Code

The inconsistencies of tax treatment for annuitants carried over to writers of private annuities, the buyers of property from the annuitants.[115] The two most important issues to annuity writers are (1) what is the basis in the property acquired in exchange for the annuity, and (2) whether the annuity writer can deduct any portion of the annuity payments as interest. The courts developed two schools of thought in resolving the two issues.

A few early decisions adopted the "venture" theory of private annuities, applying the concepts used in commercial annuities.[116] These courts, basing their analysis on an analogy to commercial annuities, computed the actuarial value of the annuity at the time of the exchange and used that as the annuity writer's basis in her property.[117] The theory of commercial annuities also recognizes that the time value of money, or interest, is a part of each annuity payment, and so courts following the venture approach allowed annuity writers an interest deduction.[118]

The majority of decisions, and particularly the later cases, adopt a "capital expenditure" approach to the treatment of annuity writers.[119] Under this approach, the courts viewed the annuity writer as merely acquiring property for a series of capital investments. Under the capital expenditure approach, the "interest" element of each annuity payment is treated as a capital expenditure. Instead, each annuity payment is merely another addition to the basis of the

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115. For excellent reviews of the pre-1954 cases and rulings on the tax consequences of annuity writers, see Davey, *Property Exchanged for a Promise to Pay an Annuity—Transferee Problems*, 33 Taxes 494 (1955); Meyer, *Transfer of Property for an Annuity—Tax Position of the Transferee*, 31 Taxes 645 (1953); and *Galvin*, *infra* note 116.

116. Galvin, *Income Tax Consequences of Agreements Involving Non-Commercial Annuities*, 29 Tex. L. Rev. 469, 491-506 (1951).

117. *Id.* at 504.

118. *Id.* at 493.

119. Steinbach Kresge Co. v. Sturgess, 33 F. Supp. 897, 898 (D.N.J. 1940).

acquired property, which slowly builds up as the annuity writer makes annuity payments.[120]

Courts intended to make the tax consequences of private annuities for annuitants and annuity writers consistent. The early decisions, like *Florence Klein*,[121] that applied the theory of commercial annuities to the taxation of annuitants were consistent with the cases that applied the "annuity venture" approach to annuity writers.[122] On the other hand, decisions that used an open transaction model for the annuitant were consistent with decisions that applied the capital expenditure approach to annuity writers. Therefore, the capital expenditure approach soon triumphed over the annuity venture approach in determining the tax treatment of annuity writers.[123]

### A. *Basis of Property Acquired by the Annuity Writer*

The earliest decision dealing with the basis problem is *Steinbach Co. v. Commissioner*[124] in 1926. In order to shift control of his corporation to his two sons, the taxpayer transferred all of his common stock and over half of his preferred stock in the Steinbach Co. to the corporation in exchange for an annuity. The Board of Tax Appeals was asked to determine the proper cost of the treasury stock entered on the books of the corporation. Using available mortality tables, the Board computed the number of expected payments. The Board then multiplied the number of expected payments by the amount of each payment to establish the price of the treasury stock. The Board then decided that any "actual expenditures in excess of the above estimate" be added to the cost of the treasury stock.[125]

Although the Board's decision reflects some parts of an annuity venture approach to the basis problem, the Board's solution really reflects a simple, capital expenditure view of the annuity transaction.[126] While the Board permitted the taxpayer to treat an estimate

120. *Id.*

121. Klein v. Commissioner, 6 B.T.A. 617 (1927).

122. *Galvin, supra* note 116, at 491-506. The court in Commissioner v. John C. Moore Corp., 42 F.2d 186 (2d Cir. 1930), relied heavily upon the *Klein* decision.

123. *Galvin, supra* note 116, at 491-506.

124. Steinbach C. v. Commissioner, 3 B.T.A. 348 (1926).

125. *Id.* at 354.

126. An early I.R.S. ruling denied the annuity writer any interest deduction. I.T. 1242, I-1 C.B. 61 (1922). All payments had to be capitalized until the total reached the actuarial value

of the total expected payments to be used as basis, an approach consistent with the annuity venture theory, the Board's analysis was too simple. The Board included no interest element or discount for the time value of money. In addition, the Board permitted the taxpayer to increase basis by amounts expended in excess of the court's original estimate of basis. Therefore, the Board treated the basis as an investment in installments without interest, even though the Board was willing to give the annuity writer's basis a head start, beginning with the present value of the annuity payments as the writer's original basis.

A later decision systematically applied the actuarial principles of annuities, the annuity venture approach, to determine the basis of the real estate acquired in exchange for an annuity. In *John C. Moore Corp. v. Commissioner*,[127] Hattie Moore transferred buildings that the corporation had occupied under a lease to the corporation in exchange for an annuity. The Board determined that the proper basis was the present value of the annuity at the time of transfer. The court pointed out that each payment must be discounted to present value, reflecting the time value of money. Only after each expected payment over the life expectancy of the annuitant had been discounted could they be added together to provide a basis in the buildings.[128] The Board's decision correctly reflected the economics of annuities.

Most of the courts, however, determined the annuity writer's basis on a "capital expenditure" basis, by just adding up the total of payments made to the annuitant.[129] Most courts denied the annuity writer even an initial, estimated basis determined by the life expectancy of the annuitant. Instead, the cases required the annuity writer to begin with no basis and to increase the basis of acquired property by the amount of each payment as it was made.[130]

### B. Revenue Ruling 55-119

Because they could only decide the narrow question before them, court decisions provided guidance on only a few of the possible

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of the annuity. The ruling then allowed the annuity writer to deduct payments in excess of the actuarial value of the annuity as a loss. Later rulings, however, required buyers in a private annuity to treat all payments made to the annuitant as capital expenditures. I.T. 1662, II-1 C.B. 121 (1923).

127. 15 B.T.A. 1140 (1929), *aff'd* 42 F.2d 186 (2d Cir. 1930).
128. *John C. Moore Corp.*, 15 B.T.A. 1140, 1144.
129. Galvin, *supra* note 116, at 496.
130. Steinbach Kresge Co. v. Sturgess, 33 F. Supp. 897 (D.N.J. 1940).

problems faced by a taxpayer needing to calculate the basis of property acquired in exchange for a private annuity. Only a ruling or regulation, which could consider several variations on a representative problem, could illustrate how the basis of property should be computed. The Service's eventual solution to the basis problem was a ruling designed to be a comprehensive answer to questions of basis in property acquired for private annuities.[131] The ruling was founded upon the notion that the basis should be the total amounts paid by the annuity writer to the annuitant.[132] The taxpayer was permitted to use actuarial values to approximate the value of the annuity, however, when adding up the payments produced unworkable results.[133]

### 1. *General Rules for Figuring Basis*

Reflecting the capital expenditure theory as the fundamental approach of the ruling, the basis of a non-depreciable property sold after the death of the annuitant was the sum of the payments made to the annuitant under the annuity.[134] Using the annual amounts paid under the annuity as the basis of the acquired property for depreciation purposes, however, would be difficult to administer.[135] The ruling, therefore, established the actuarial value of the annuity, determined according to the tables in the Regulations, as the basis of the acquired property for purposes of computing depreciation.[136] However, the ruling required the annuity writer, after the decedent's death, to revise the property's depreciation schedule to conform to the sum of annuity payments actually made.[137]

131. Rev. Rul. 55-119, 1955-2 C.B. 352 (hereafter Rev. Rul. 55-119) (construing the provisions of the 1939 Code).
132. *Id.* at 353.
133. The actuarial value was used for computing depreciation, and for computing gain when the annuity writer transferred the property while the annuitant was still alive. *Id.* at 353, 354.
134. *Id.* at 354.
135. Compare another example of contingent purchase price, the depreciation of patents. Patents being acquired for royalties based upon the income from the patent involve similar uncertain payments. The royalties paid by the purchasers are treated as the annual amount of depreciation. Associated Patentees, Inc. v. Commissioner, 4 T.C. 979 (1944). The royalties, however, will only be paid for the life of the patent, and the royalties are related to the value of the patent. In the case of property acquired for a private annuity, however, the amount which may be paid depends on the life of the annuitant. The only time at which the annuity's value and the value of the property will certainly correspond is at the date of grant. After that, the life of the annuitant and the total paid for the property may have nothing to do with the value or economic life of the property. Therefore, an approach like that used in patent cases is inappropriate.
136. Rev. Rul. 55-119, 1955-2 C.B. 352, 353.
137. *Id.* at 354.

The ruling's example illustrates how the general principles of the ruling should be applied. The ruling involved the purchase of land worth $15,000 and a building worth $80,000 for an annuity of $10,000 per year with a present value of $94,785. The basis of the land and building, for purposes of computing depreciation, was $94,785. Based upon this value, the building was depreciated on a straight-line basis at $1,296 per year (assuming a fifty-year life and $15,000 salvage value).[138] At the death of the annuitant, however, the depreciation schedule would be corrected to reflect the annuity payments actually made. In the example, the annuitant died after eight years, and $80,000 in payments had been made, requiring the annuity writer to reduce the amount of annual depreciation taken to $999.94 to reflect the lower basis of the property.[139]

### 2. *Dispositions During the Annuitant's Life*

Finally, the ruling provided for two different bases for property sold during the life of the annuitant, one for determining gain and another for determining loss. For purposes of computing loss, the basis of the property was the sum of the annuity payments made up to the date of disposition.[140] For purposes of determining gain, however, the ruling required the seller to add the total payments already made to the actuarial value of the expected payments to be made on the annuity, computed using the tables in the Regulations based on the annuitant's life expectancy at the date of the disposition of the property.[141] If the amount realized on the sale of the property was less than the basis for gain purposes but more than the basis for loss purposes, the annuity writer would recognize neither gain nor loss on the sale.[142]

A simple example, based in part on the example in the ruling, shows how the dual basis rule applies in practice. If we assume that

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138. *Id.* at 355. The formula was [$80,000 (value of bldg.)/$95,000 (value of bldg. plus land)] times [$94,785 (value of annuity) - $15,000 (salvage value)] to produce the portion of the basis attributable to the building that could be depreciated. The resulting figure was divided by 50 (the useful life of the building) to produce the depreciation deduction. *Id.*

139. *Id.* at 355. The new formula for depreciation would be: [$80,000 (value of the building)/$95,000 (value of the land and building)] times [$80,000 (total payments made to the annuitant) - $15,000 (salvage value) - $10,371.04 (depreciation already taken). The result, the amount of the building's basis available for depreciation would be divided by 42 years (the remaining useful life of the building) for an annual depreciation of $999.94.

140. *Id.*

141. *Id.*

142. *Id.*

the property was a capital asset, and that it was sold after nine years of payments had been made, the basis for purposes of determining loss would be $90,000, the sum of the payments made before the sale. The basis for purposes of determining gain would be $90,000 (the payments made), plus the value of the annuity for the annuitant (age seventy-eight at the date of sale), $63,705, for a total of $153,705.[143] A sale for less than $90,000 would produce an immediate loss. A sale for $90,000 to $153,705 would produce neither gain nor loss, and a sale for more than $153,705 would produce a gain.

### 3. *Basis Adjustments after Disposition*

Because the annuity writer would still be liable to make payments after disposing of the property, however, events occurring after the disposition of the property could affect the gain or loss on the sale of the property. If the annuitant recognized a loss on the sale, for example, all payments made after the disposition of the property would constitute an additional loss in the years paid.[144] A gain or loss could also occur in a case in which the annuity writer recognized no loss on the original disposition of the property. If the payments to the annuitant eventually exceeded the amount realized on the sale, each dollar paid to the annuitant in excess of the amount realized would be loss recognized at the time the excess payments were made, but characterized by the disposition of the property.[145] If the total amounts eventually paid to the annuitant were less than the amount realized on the disposition of the property, however, the annuity writer would recognize gain in the year of the annuitant's death. In situations in which gain was originally recognized, gain or loss could eventually result, depending on whether the total amount eventually paid to the annuitant was greater or less than the gain basis originally used on disposition of the property.[146]

### 4. *Evaluation of Revenue Ruling 55-119*

The ruling prescribes a thorough and generally reasonable procedure for determining basis in private annuity sales. The ruling is

143. *Id.* at 355-56.
144. *Id.*
145. *Id.* at 354-355.
146. *Id.*

complex, both in concept and in use, but taxpayers with enough property to make such a transaction attractive will need, and can probably afford, competent counsel able to find and apply these complex rules. *Revenue Ruling 55-119* also has weaknesses that are not immediately apparent. For example, one can imagine a situation in which an annuitant's life expectancy was longer than the period used to depreciate the acquired property. Assume that the annuitant with a life expectancy of fifteen years sold five-year class property to her nephew in exchange for a private annuity. If the actuarial determined value of the annuity were $10,000, then the nephew would have claimed $10,000 of depreciation deductions by the end of year six and the adjusted basis of the property would be zero. If the annuitant then died in the seventh year, *Revenue Ruling 55-119* would require the nephew to reduce his basis to the sum of payments actually made, and that amount could be less than the original basis used by the nephew to compute depreciation. The nephew would have a negative basis in the property.[147] The ideal solution would be to have the nephew recapture the excess depreciation taken as income in the year the annuitant died, but this could not be required without an amendment to the Code.[148]

The court rulings deciding how annuity writers should determine the basis of property acquired in exchange for private annuities initially flirted with the "venture theory" of annuities, relying on the mathematical theory underlying annuities. The later court decisions, however, settled on a capital expenditure theory for the property's basis, requiring annuity writers to use the sum of payments made as the basis of property acquired for a private annuity. *Revenue Ruling 55-119* finally rationalized the inconsistent analysis of the cases and filled in the gaps in the applicable court decisions. The ruling provided a complete and detailed scheme under many circumstances for determining the basis of property acquired for a private annuity, and it is still in use, thirty-four years later.

### *C. Interest Deduction*

The development of the law governing interest deductions for annuity writers reached the same result as that described above for

147. Zaritsky, *The Use of Private Annuities in Estate Planning: Problems, Opportunities, and a Viable Alternative*, 32 S.C.L. Rev. 359, 366 n.29 (1980).
148. *Id.*

basis issues, a capital expenditure theory of annuities. The reasoning of the interest cases, however, differed somewhat from the reasoning in the basis cases.

Interest is usually defined as "compensation for the use or forbearance of money."[149] As the previous discussion indicates, the valuation of annuities and their computation reflects primarily two factors, the life expectancy of the annuitant and the interest to be earned by the principal sum deposited in exchange for the annuity.[150]

Most of the cases and rulings, however, have refused to allow annuity writers to deduct as interest any portion of the amounts paid to an annuitant. The Internal Revenue Bureau began the trend of denying the interest deduction in a 1922 ruling,[151] and the case law has generally followed this trend. The circumlocutions used by some judges to deny taxpayers the interest deduction make clear how difficult it is to deny that annuities contain an interest component. One court, denying that the three percent ordinary income component required by the 1934 tax legislation was interest, stated that the ordinary income was "not interest in the ordinary sense of that term, but a return on capital in the nature of interest."[152]

The Board of Tax Appeals in *Edwin Klein*,[153] deciding whether an annuity writer deserved an interest deduction, had to contradict its holding in a previous decision. The Board had already decided in *Florence Klein*[154] that the annuitant under the same annuity contract had received ordinary income in the nature of interest. The theory of the *Florence Klein* case was that each annuity payment had to be discounted to account for the time value of money, and that the discount was interest.[155] The Board quoted a portion of the Black's Law Dictionary definition of discount as " . . . the taking of interest in advance."[156] In the *Edwin Klein* case, the Board attempted to distinguish its previous holding in *Florence Klein*. To perform this feat of rhetorical gymnastics, the Board then stated that the term "discount" "is not used in the instant proceeding" in the sense of

149. Deputy v. Du Pont, 308 U.S. 488, 498 (1940).
150. *See supra* note 29 and accompanying text.
151. I.T. 1242, I-1 C.B. 61 (1922).
152. F. A. Gillespie & Sons Co. v. Commissioner, 154 F.2d 913, 918 (10th Cir. 1946).
153. Klein v. Commissioner, 31 B.T.A. 910 (1934).
154. Klein v Commissioner, 6 B.T.A. 617 (1927). *See supra* note 69 and accompanying text.
155. Klein v. Commissioner, 6 B.T.A. 617.
156. BLACK'S LAW DICTIONARY (3d ed.) *quoted in* Klein v. Commissioner, 31 B.T.A. 910, 919.

interest, without explaining how interest for one party in a transaction could not be interest for the other party in the same transaction.[157]

Much of the failure to recognize discount as interest resulted from the simple conception of interest embedded in the early income tax case law. In *Old Colony R.R. v. Commissioner*,[158] the Commissioner had attempted to reduce the taxpayer's interest deduction by a pro rata share of the company's bond premium. After explaining how investors took bond premium into account in figuring their return on investment, Justice Roberts construed the term "interest" to denote a somewhat over-simplified, common meaning. The court defined interest as "the amount so denominated in bond and coupon," and rejected any expansion of the definition to "some esoteric concept derived from subtle and theoretic [sic] analysis."[159] The absence of a stated principal sum and stated interest rate was the most common reason for disallowing interest deductions in pre-1954 private annuity cases.[160]

The tax rules governing private annuities before 1954 did not reflect the economic principles underlying annuities. Annuitants were required to recognize a portion of each payment as ordinary income, similar to interest. To compute the ordinary income component, the annuitant multiplied three percent by the actuarial value of the annuity contract at the time of its acquisition.[161] The three-percent rule applied even though the rate of return on the annuity contract might be quite different from three percent. The annuitant in a private annuity treated the remaining "principal" portion of each annuity payment as a tax-free return of basis until the basis of the property exchanged had been recovered. The principal portion of any remaining payments were treated as gain from the sale of the property. Annuity writers, however, were treated as paying only principal, not interest, in exchange for the property they acquired.

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157. Klein v. Commissioner, 31 B.T.A. 910, 919.

158. Old Colony R.R. Co. v. Commissioner, 284 U.S. 552 (1932).

159. *Id.* at 561.

160. F.A. Gillespie & Sons Co. v. Commissioner, 154 F.2d 913 (10th Cir. 1946); Corbett Inv. Co. v. Helvering, 75 F.2d 525 (D.C. Cir. 1935); Steinbach Kresge Co. v. Sturgess, 33 F. Supp. 897 (D.N.J. 1940); Reliable Incubator & Brooder Co. v. Commissioner, 6 T.C. 919 (1946); Klein v. Commissioner, 31 B.T.A. 910, 916 (1934). One reason for denying a deduction for interest was that the income tax statutes during this period allowed deductions for "interest paid or accrued . . . on indebtedness," (Revenue Act of 1924 § 214(a)(2)), and the courts found no conventional indebtedness upon which interest was being paid. *See, e.g.*, Klein v. Commissioner, 31 B:T.A. at 918-919.

161. I.R.C. 1939, § 22(b)(2) (1939).

## IV. Treatment of Private Annuitants under the 1954 Code

### *A. General Taxation of Annuitants In Section 72*

As a part of the general revision of the federal tax laws in 1954, Congress enacted a new scheme for taxing annuities in section 72 of the 1954 Internal Revenue Code.[162] Rather than imposing a statutory rate of return for annuity contracts, the new statutory scheme depended only on the terms of the contract and the annuitant's life expectancy. Thus section 72 allow a more individualized treatment of annuity transactions. Section 72 required each taxpayer to divide each payment received between tax-exempt return of principal and ordinary income.[163] Computing the exempt portion of each payment required application of a formula:

Investment in the Contract x Payment Received/Expected Return from the Contract.[164]

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162. I.R.C. § 72(a)-(c) (1954).

163. The relevant portions of Internal Revenue Code section 72(a)-(c) (1954) provided as follows:

> § 72. Annuities; certain proceeds of endowment and life insurance contracts
>
> (a) General rule for annuities.—Except as otherwise provided in this chapter, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract.
>
> (b) Exclusion ratio.—Gross income does not include that part of any amount received as an annuity under an annuity, endowment or life insurance contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date). This subsection shall not apply to any amount to which subsection (d)(1) (relating to certain employee annuities) applies.
>
> (c) Definitions.—
>
> (1) Investment in the contract.— For purposes of subsection (b), the investment in the contract as of the annuity starting date is—
>
> (A) the aggregate amount of premiums or other consideration paid for the contract, minus
>
> (B) the aggregate amount received under the contract before such date, to the extent that such amount was excluded from gross income under this subtitle or prior income tax laws.
>
> * * *
>
> (3) Expected return.—For purposes of subsection (b), the expected return under the contract shall be determined as follows:
>
> (A) Life expectancy.—If the expected return under the contract, for the period on and after the annuity starting date, depends in whole or in part on the life expectancy of one or more individuals, the expected return shall be computed with reference to actuarial tables prescribed by the Secretary or his delegate.

I.R.C. § 72.(a)-(c) (1954).

164. I.R.C. § 72(b) (1954). The House had passed a proposal to adopt annuity rules similar

The investment in the contract was the amount of consideration paid for the contract, for instance, the premiums paid under a conventional annuity contract from an insurance company.[165] The taxpayer computed the expected return from the contract by multiplying the annual payment under the contract by the life expectancy of the annuitant.[166] The Code required all annuitants to use life expectancy tables promulgated by the Treasury Department.[167] Somewhat more complex calculations were required in cases involving annuities on more than one life or annuities with refund features.[168] In treating the risk of mortality, however, the 1954 Code treated annuitants as a population rather than as individuals. Once computed, the exclusion ratio for each annuity was fixed.[169] Annuitants who outlived their life expectancies continued to receive the benefit of excluding a portion of the payments received, while annuitants who died before recovering all of their capital received no deduction.[170]

*B. Congressional Background of Section 72*

Both the American Law Institute[171] and the House of Representatives[172] had recommended comprehensive approaches to

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to those of the 1954 Code in 1948, but the proposal died in the Senate. H.R. 6712, 80th Cong., 2d Sess. § 104(a) (1948).

165. I.R.C. § 72(c)(1) (1954).

166. I.R.C. § 72(c)(3) (1954). An illustration of the operation of the general rules section 72 follows: Aunt Anne, age 79, purchases an annuity of $15,000 per year for $100,000 from the Incredibly Reliable Insurance Company. The first step is to compute Anne's expected return by multiplying the annual payment under the annuity, $15,000, by Anne's expected return multiple of 10.0 (from Treas. Reg. § 1.72-9, Table V, T.D. 8115, 1987-1 C.B 22, 39). I.R.C. § 72(c)(3)(A). Anne has an expected return of $150,000. Next Anne's tax preparer computes the exclusion ratio, by dividing Anne's investment in the contract, $100,000, by her expected return, $150,000, for an exclusion ratio of 2/3 or .6667. Treas. Reg. § 1.72-4(a)(1)(i), T.D. 6211, 1956-2 C.B. 29, 36. Anne's tax preparer multiplies the exclusion ratio, .6667, by the total amount received under the annuity during the tax year, $15,000, for an exclusion from gross income of $10,000. Treas. Reg. § 1.72-4(a)(1)(ii), T.D. 624, 1956-2 C.B. 29, 37. Finally, Anne subtracts her exclusion, $10,000, from the total she received during the year under the annuity, $15,000, to yield gross income from the annuity of $5,000. I.R.C. § 72(a), (b)(1) (1954).

167. I.R.C. § 72(c)(3) (1954).

168. I.R.C. § 72(c)(2), (c)(3)(A).

169. Treas. Reg. § 1.72-4(a)(4), T.D. 6211, 1956-2 C.B. 29, 37. The exclusion ratio could not be used if the contract were transferred for valuable consideration, were redeemed, or were exchanged. *Id.*

170. 2 TAX REFORM ACT OF 1986, CONFERENCE REPORT TO ACCOMPANY H.R. 3838, H.R. REP No. 99-841, 99th Cong., 2d Sess. II-459 (1986).

171. FEDERAL INCOME TAX STATUTE § X126(f)(1)(A) (February, 1954, Draft).

172. H.R. CONF. REP. 2543, *Conference Report on Internal Revenue Code of 1954*, 83rd Cong., 2d Sess. 71 (1954).

computing the gain or loss from appreciated property exchanged for a non-commercial annuity. However, the 1954 Code provided no guidance on how basis should be recovered or how gain or loss should be reported in transfers of property for annuities. Section X126 of the ALI Federal Income Tax Statute generally followed the later scheme adopted in the Internal Revenue Code of allocating each annuity payment received between return of principal and ordinary income.[173] In addition, the ALI statute established a general rule of closed transaction treatment on the exchange of property for annuities.[174] The ALI proposal, however, permitted annuitants to elect to recognize the gain and recover the basis in the property ratably over the payments to be received.[175]

In its version of the 1954 Code, the House of Representatives proposed a simple, comprehensive, albeit somewhat drastic, solution to the "conflicting court decisions" regarding the private annuity problem.[176] Instead of allowing annuitants to spread the gain in their transferred property over their life expectancies, the proposed section would have required annuitants to treat the actuarial determined value of the annuity received as a part of the amount realized for their property upon transfer in exchange for the annuity.[177] In a transfer of property solely for a private annuity not involving a gift, the entire amount of gain inherent in the property would have been recognized upon the transfer. The value of the annuity would then have been the annuitant's investment in the contract for purposes of section 72.[178] The proposed provision also allowed annuity writers a deduction for the ordinary income portion of amounts paid to annuitants.[179] Finally, the House's bill provided that the value of the annuity would be used to compute the basis of the property transferred to the annuity writer, subject to recomputation for mortality gains or losses.[180] The provision did not appear in the Senate version, and, in conference the House receded "to provide an opportunity for further study."[181]

173. FEDERAL INCOME TAX STATUTE § X126(a)-(c) (February, 1954, Draft).
174. *Id.* at § X126(f)(1)(A).
175. *Id.* at § X126(f)(1)(B).
176. H.R. CONF. REP. 2543, *Conference Report on Internal Revenue Code of 1954*, 83d Cong., 2d Sess. 71 (1954).
177. *Id.*
178. *Id.* at A286-87.
179. *Id.* at A287.
180. *Id.* at A287-88.
181. H.R. CONF. REP. No. 2543, 83d Cong., 2d Sess., 71,

The 1954 Code as finally enacted resolved the problem of allocating annuity payments between investment return and return of principal but left to the courts and the Internal Revenue Service the task of allocating the principal portion of each payment between return of basis and gain in annuities received in exchange for appreciated property. While there were no cases after enactment of the 1954 Code directly on point, apparently, at least in the Tax Court, the seller's gain in appreciated property exchanged for an unsecured private annuity would be recognized only after the adjusted basis in the property had been exhausted.[182]

### C. *Ratable Reporting of Gain and Rev. Rul. 69-74*

The open transaction treatment for private annuities is very beneficial for annuitants. After 1954, both the government and the courts made decisions that had the effect of reducing the availability of open transaction treatment for private annuitants. Beginning in 1969, the Internal Revenue Service issued *Revenue Ruling 69-74*,[183] and the Treasury Department issued a Regulation[184] that, while resting on inconsistent theories, both required taxpayers to treat the excluded, or principal, portion of a private annuity as partially a return of basis and partially as gain. The Claims Court has followed the government's "ratable recovery of gain" approach.[185] By contrast, the open transaction approach used in the *Lloyd* case[186] allowed the taxpayer to treat the entire excluded portion of an annuity payment as tax-free return of basis until the basis in the exchanged property was exhausted.[187] The Tax Court, while not adopting a ratable recovery of gain approach, narrowed the availability of open transaction treatment by deciding that secured private annuities should be treated as closed, rather than open, transactions.[188]

The Internal Revenue Service in *Revenue Ruling 69-74*[189] attempted to abolish open transaction treatment of private annuities in favor

182. Edgar v. Commissioner, 56 T.C. 717, 742 n.15 (1971).
183. Rev. Rul. 69-74, 1969-1 C.B. 43.
184. Treas. Reg. 1.1011-2, example (8), T.D. 7207, 1972-2 C.B. 106.
185. Garvey, Inc. v. United States, 1 Cl. Ct. 108 (1983), *aff'd* 726 F.2d 1569 (Fed. Cir. 1984).
186. Lloyd v. Commissioner, 33 B.T.A. 903 (1936), *nonacq.* XV-2 C.B. 39 (1936), *nonacq. withdrawn and acq.* 1950-2 C.B. 3. *See supra* notes 74-81 and accompanying text.
187. *See supra* notes 113-114 and accompanying text (discussing Revenue Ruling 239).
188. Bell v. Commissioner, 60 T.C. 469 (1973).
189. Rev. Rul. 69-74, 1969-1 C.B. 43. Revenue Ruling 69-74 has been strongly criticized.

of a ratable recovery of both basis and gain in the principal portion of each annuity payment. The Service ignored the *Lloyd* case completely and attempted to resolve all of the issues of the annuitant under the concepts of section 72. The Ruling first established the value of the private annuity by computing its value under the actuarial tables of the valuation sections of the estate tax regulations.[190] The ruling used this value, reduced by the adjusted basis of the property exchanged for the annuity, to compute the gain inherent in the property at the time of the exchange.[191] The Service then defined the taxpayer's investment in the annuity contract, the numerator of the exclusion ratio described by section 72, as the adjusted basis of the property the taxpayer had transferred in exchange for the annuity.[192] The Service's previous ruling, *Rev. Rul. 239*, had treated the fair market value of the property exchanged for the annuity as the investment in the contract, thus leaving the treatment of gain recognition in appreciated property outside the annuity rules.[193] By reversing its former position on the investment in the contract, the Service could then apply the rules of section 72 to the timing of gain recognition in private annuity transactions. The Service ruled that the capital gain income be ratably recovered over the life expectancy of the annuitant. After the entire capital gain had been reported, the entire annuity payment in excess of the exclusion would be ordinary income.[194]

The Treasury Department established yet another scheme for computing gain recognition in private annuities in Regulation 1.1011-2[195] in 1972. The Regulation was inconsistent in concept with both *Rev. Rul. 69-74* and the *Lloyd* case.[196] The new Regulation applied to

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*See* Stewart, *Private Annuities—Revenue Ruling 69-74 Partially Repudiated, Sub Silentio, By Treasury Regulation Section 1.1011-2(c), Example (8)*, 24 MERCER L. REV. 585 (1973); Raiborn & Watkins, *Critical Analysis of Private Annuity Taxation*, 50 TAXES 11 (1972); Note, *Private Annuities: Revenue Ruling 69-74—Its Significance, Effect, and Validity*, 23 VAND. L. REV. 675 (1970); Comment, *Tax: Income Tax Consequences of the Private Annuity*, 41 MISS. L.J. 457 (1970).

190. Rev. Rul. 69-74, 1969-1 C.B. 43.

191. *Id.* at 44.

192. *Id.*

193. Rev. Rul. 53-239, 1953-2 C.B. 53.

194. Rev. Rul. 69-74, 1969-1 C.B. 44. 1969-1 C.B. 44.

195. Treas. Reg. 1.1011-2(c) example 8, T.D. 7072, 1972-2 C.B. 106, 163. The amendment was a part of an extensive revision of the Regulations applicable to charitable contributions. Congressional amendments to the charitable contribution rules in the 1969 Tax Reform Act made the Reg. amendments necessary. Tax Reform Act of 1969, Pub. L. No. 91-172, § 170, 83 Stat. 487 (1969).

196. *See* Stewart, *supra* note 189, at 590, 617; Rev. Rul. 69-74, 1969-1 C.B. 44, Lloyd v.

bargain sales to a charity, that is, transactions in which an individual transferred appreciated property to a charity in exchange for an annuity and in which the value of the property transferred was greater than that of the annuity.[197] The example involved a transfer of property worth $100,000 with a $20,000 adjusted basis by a sixty-five year-old man to a charity in exchange for an annuity of $5,000 per year. Using the estate tax valuation tables, the regulation valued the annuity at $59,755. Using the actuarial value of the annuity, the example allocated $11,951 of the basis in the property to the exchange, and computed a gain of $47,804 on the exchange.[198] Contrary to *Rev. Rul. 69-74*, the example treated the value of the annuity, not the basis of the property exchanged for the annuity, as the investment in the contract for annuity purposes.[199] Contrary to the *Lloyd* case and consistent with *Rev. Rul. 69-74*, the example required the annuitant to prorate his capital gain over his life expectancy. Thus, the government consistently ruled that the gain in exchanges of appreciated property for annuities should be recovered ratably over the life expectancy of the annuitant but reached that result under inconsistent theories.

Neither Regulations nor Revenue Rulings are written in such a way as to disclose the reasoning behind their decisions.[200] The Claims Court opinion in *Garvey, Inc. v. United States*,[201] however, provides a rationale for the government's ratable recovery approach. The *Garvey* case involved the transfer of appreciated property by several individuals to corporations in exchange for unsecured annuities.[202] The Court of Appeals opinion holds that the annuitants should pro rate their bases over their life expectancies, consistent with both *Rev. Rul. 69-74* and Treas. Reg. § 1.1011-2(c) example 8, without deciding whether basis or fair market value determined the investment in the contract.[203] The trial court opinion in *Garvey*, however, seems clearly

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Commissioner, 33 B.T.A. 903 (1936), *nonacq.* XV-2 C.B. 39 (1936), *nonacq. withdrawn and acq.* 1950-2 C.B. 3.

197. Treas. Reg. 1.1011-2(a), T.D. 7207, 1972-2 C.B. 106, 162.

198. *Id.* at 165.

199. *Id.* at 165. The Treasury changed its approach to the definition of "investment in the contract" to conform to the criticism of the Rev. Rul. 69-74 in the *Bell* case, *infra* note 211. O.M. 17802, discussed in Gen. Couns. Mem. 35552 (Nov. 6, 1973).

200. Some of the government's reasoning can be gleaned from Gen. Couns. Mem. 37371 (Dec. 22, 1977); Gen. Couns. Mem. 35552 (Nov. 6, 1973); O.M. 17802 (1972); and Gen. Couns. Mem. 33656 (Oct. 17, 1967).

201. Garvey, Inc. v. United States, 1 Cl.Ct. 108 (1983), *aff'd* 726 F.2d 1569 (Fed. Cir. 1984).

202. *Garvey, Inc.*, 1 Cl. Ct. 108, 120.

203. Garvey, Inc. v. United States, 726 F.2d 1569, 1573 (Fed. Cir. 1984).

to rely on using the annuitant's basis as the investment in the contract.[204] Arguing that Congress only intended the annuitant to be able to recover his or her investment tax-free, the court concludes that the return of capital "is necessarily limited to a return of the annuitant's basis for the property exchanged."[205] In holding that open transaction treatment should not be applied to private annuities, the court notes that the scope of open transaction treatment had narrowed since the decision of the original open transaction case, *Burnet v. Logan*. The court's research revealed that recent cases had required courts to find a value for contract rights "*except in rare and extraordinary cases*."[206] Relying on *United States v. Davis*,[207] the court also argued that, even if the annuity contract received by the sellers could not be valued, the contract could be valued because the consideration exchanged for the annuity in an arm's length transaction could be presumed to be equal in value to the annuity.[208] Finally, the court relied on the legislative history of the annuity provisions to argue that ratable recovery of gain was the only method consistent with ratable recovery of capital.[209] While *Lloyd* and its progeny are not mentioned in *Garvey*, the court was clearly aware that it was departing from applicable precedent.[210]

Unlike the Claims Court and the Court of Appeals for the Federal Circuit, the Tax Court rejected the ratable recovery approach to

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204. *Garvey, Inc.*, 1 Cl. Ct. 108, 124-25.

205. *Id.* at 125.

206. *Id.* at 123, *quoting* McCormac v. United States, 424 F.2d 607, 619 (Cl. Ct. 1970) (emphasis in both *McCormac* and *Garvey*).

207. 370 U.S. 65 (1962), cited by *Garvey, Inc.*, 1 Cl. Ct. 108, 123.

208. Garvey, Inc. v. United States, 1 Cl. Ct. 108, 123-24.

209. *Id.* at 124-25.

210. *Id.* at 125 n.20 (1983). In support of their adoption of a ratable gain approach, rather than the historically accepted open or closed transactions, the court added the following footnote: *See* Learned Hand, "How Far is a Judge Free in Rendering a Decision?" (Radio Broadcast, May 4 [sic], 1933) *reprinted in The Spirit of Liberty—Papers and Addresses of Learned Hand (I Dillard ed. 1960),* at 106:

> "How does [the judge] in fact proceed? Although at times he says and believes that he is not doing so, what he really does is to take the language before him, whether it be from a statute or from the decision of a former judge, and try to find out what the government, or his predecessor, would have done, if the case before had been before them. He calls this finding the intent of the statute or of the doctrine. This is often not really true. The men who used the language did not have any intent at all about the case that has come up; it had not occurred to their minds. Strictly speaking, it is impossible to know what they would have said about it, if it had. All they have done is to write down certain words which they mean to apply generally to situations of that kind."

*Id.*

private annuities. Instead, in *Estate of Bell v. Comm'r.*,[211] the Tax Court limited the sweep of the *J. Darsie Lloyd* case by distinguishing it. Lloyd and Grace Bell had transferred stocks to their son and daughter and their spouses in exchange for a secured, rather than an unsecured, joint and survivor annuity. To secure the performance of the annuity writers, the annuity agreement required that the stocks be escrowed and also provided for "a cognovit judgment against the transferees in the event of a default."[212] The court recognized that the *Lloyd* decision rested not upon a determination that the private annuity written by J. Darsie Lloyd was subject not only to the uncertainty that Harold Lloyd might die, but upon a determination that J. Darsie Lloyd might be unable to make the payments under the annuity.[213] The escrow and the cognovit provision substantially reduced the risk of the annuitants under the annuity. This reduced risk allowed the court to use actuarial tables to find a fair market value for the annuity. Because the court found that the annuity had a fair market value, the transaction had to be closed for tax purposes, and all of the gain in the transaction had to be recognized at the date of the transfer.[214] The dissent would have adopted a ratable recognition rule similar to that prescribed by *Rev. Rul. 69-74*.[215] According to Judge Simpson's dissent, the annuitant's gain should have been prorated over the annuitant's life expectancy, analogizing the gain proration to the ratable recognition of ordinary income under section 72.[216] The dissenters, however, rejected the concept underlying the Revenue Ruling, that the annuitant's adjusted basis in his property was his investment in the contract, as being inconsistent with the previous decisions of the Tax Court.[217]

In summary, during the 1960's and 1970's, the courts and the government narrowed the scope of the favorable, "open transaction" treatment traditionally available to private annuitants. The govern-

211. 60 T.C. 469 (1973). *See also* Note, *Private Annuities: Closed Transactions? Estate of Lloyd G. Bell, 60 T.C. 469 (1973)*, 28 MIAMI L. REV. 445 (1974); Note, *Income Tax—Section 72—Definition of Exclusion Ratio and Treatment of Capital Gain Element in a Private Annuity. Estate of Lloyd G. Bell, 60 T.C. 469 (1973)*, 52 TEX. L. REV. 149 (1973). On this point, *Bell* was followed by 212 Corp. v. Commissioner, 70 T.C. 788 (1978). *See also* Note, *Private Annuities—Capital Gain Treatment for Private Annuities—212 Corporation v. Commissioner*, 15 WAKE FOREST L. REV. 724 (1979).

212. Estate of Bell v. Commissioner, 60 T.C. at 471.

213. *Id.* at 475.

214. *Id.* at 475-76.

215. *Id.* at 476, 479 (Simpson, J., dissenting).

216. *Id.* at 477 (Simpson, J., dissenting).

217. *Id.* at 476 (Simpson, J., dissenting).

ment and the Claims Court adopted a ratable recognition scheme, requiring annuitants to report a portion of each payment as gain, and the Tax Court required annuitants receiving secured private annuities to recognize all their gain immediately.

### D. *Validity of Revenue Rule 69-74*

In an exchange of property for an unsecured private annuity, two different sets of rules potentially apply to recognition of the annuitant's gain in the property transferred for the annuity, the annuity rules or the rules governing sales of property.[218] The transaction may either be treated as a sale of property followed by the acquisition of an annuity, or as a unified transaction.[219] The first approach is in line with the case law before *Revenue Rule 69-74* and with the case of *Burnet v. Logan.* The second is the approach used in *Revenue Rule 69-74.*[220] Although the ratable recognition method departs from the traditional approach to taxing the gain of private annuitants, the use of a ratable recovery method founded upon the annuity rules is a valid construction of section 72.

Commentators arguing that *Rev. Rul. 69-74* is invalid usually contend that nothing in the legislative history justifies a change in the treatment of private annuities.[221] This argument normally relies on the fact that Congress had the opportunity to change the treatment of gain in private annuities in 1954[222] and in 1963[223] but failed to make any change. The refusal by Congress to make a change, however, cannot necessarily be considered an approval of the rules in effect at that time. The Senate's concern in 1954 that the problem needed more study before changing the law is hardly a ringing endorsement of the rules in effect in 1954.[224] A similar argument can be made to support *Revenue Ruling 69-74.* Congress had the oppor-

218. Croft & Hipple, *Planning Lifetime Property Transfers: Private Annuities, Installment Sales and Gift-Leasebacks,* 11 Real Prop., Probate, and Tr. J. 253, 263-4 (1976).

219. Note, *Private Annuities: Revenue Ruling 69-74—Its Significance, Effect, and Validity,* 23 Vand. L. Rev. 675, 683-84 (1970).

220. *Id.*

221. *Stewart, supra* note 189, at 585.

222. *See supra* notes 171-182 and accompanying text.

223. The Treasury Department submitted a Technical Memorandum proposing a change to the private annuity rules to the House Ways and Means Committee, on February 6, 1963, but nothing came of it. *See Midgley, supra* note 10, at 693 n.66.

224. *See supra* note 181 and accompanying text.

tunity to reverse the government's ratable gain position in 1980 in the Installment Sales Revision Act and refused to do so.[225]

The Tax Court has also contended that the definition of "investment in the contract"[226] used in *Rev. Rul. 69-74* is inconsistent with previously established caselaw on the issue.[227] Under the 1939 Code, the Tax Court[228] and the Service[229] had defined "investment in the contract" as equal to the fair market value of the consideration paid for the annuity. When one considers the fundamentally different statutory schemes used under the 1939 and 1954 Codes, however, the difference in interpretation becomes understandable. Both the 1954 and 1939 Codes were intended to allow annuitants to recover the investment in the contract tax-free. The annuity rules under the 1939 Code used an "add-on interest" approach, and under such a scheme, only by using the fair market value of the annuitant's consideration would the amount of "interest" income approximate the taxpayer's return on investment. The 1954 Code, on the other hand, attempts to give an exact return of the taxpayer's investment through the exclusion ratio, and then taxes the remainder of each payment. This scheme, which allows the flexibility to recognize the taxpayer's negotiated transaction, permits the flexibility to return tax-free to the taxpayer only the taxpayer's actual investment in an annuity. In the case of a private annuity received in exchange for property, the annuitant's actual investment is the basis of the property exchanged for it.[230] Thus, the private annuitant's investment in the contract should be defined as the basis of the property exchanged

225. *See infra* notes 255-263 and accompanying text.

226. "Investment in the contract" is used in the current (1954 to present) version of the annuity rules to allow the annuitant to recover the amounts that she had paid for the annuity tax-free. I.R.C. § 72(b)(1) (1954). "Investment in the contract" is defined, in part, as "the aggregate amount of premiums or other consideration paid for the contract." I.R.C. § 72(c)(1) (1954). The phrase, "aggregate premiums or other consideration paid" was adopted in the 1934 revision of the annuity rules for a similar purpose. Rev. Act of 1934 § 22(b)(2). *See supra* notes 93-103 and accompanying text. *See also* Estate of Bell v. Commissioner, 60 T.C. 469, 472 (1973). Under the rules in effect from 1934-1954, the annuitant had to report "3 percentum of the aggregate premiums or consideration paid for such annuity" as ordinary income. Rev. Act of 1934 § 22(b)(2). Under the 1954 rules, the taxpayer computes an exclusion from gross income by multiplying "investment in the contract" by the amount received under the annuity/expected return from the annuity. Treas. Reg. 1.72-4(a)(4), T.D. 6211, 1956-2 C.B. 29. *See supra* notes 162-170 and accompanying text.

227. Estate of Bell v. Commmissioner, 60 T.C. 469; 212 Corp. v. Commissioner, 70 T.C. 788.

228. de Canizares v. Commissioner, 32 T.C. 345 (1959).

229. Rev. Rul. 53-239, 1953-2 C.B. 53. *See supra* note 113 and accompanying text.

230. Garvey, Inc. v. United States, 1 Cl. Ct. 108 at 109.

for the annuity rather than the fair market value of the property.[231] Therefore, *Revenue Ruling 69-74* is a valid interpretation of section 72.

Some authorities would uphold the validity of a ratable recovery of basis approach even if "investment in the contract" is defined as the fair market value of the property exchanged for the annuity.[232] While defining the term "investment in the contract" in private annuities as the basis of the property the annuitant exchanged for the annuity is the preferable interpretation of the term, some authorities would apply a ratable recovery of basis approach even if the "investment in the contract" were defined differently.[233]

## V. The Installment Sales Revision Act and Private Annuities

In the mid-1970's, after the decision in the *Bell* case, there were three recognized approaches for recognizing the gain element in private annuities. For unsecured annuities, the government's ratable recognition under section 72, and the open transaction treatment under the *Lloyd* case, had received official blessing. If the annuity was secured, the *Bell* decision required closed transaction treatment.[234] The Installment Sales Revision Act of 1980[235] added a fourth possible gain recognition scheme, installment reporting, to the already complex law of private annuities.

### A. *History of Installment Reporting*

Before the Installment Sales Revision Act, the installment sales provisions of the Code did not apply directly to private annuities. The concepts of installment sale reporting grew up as an administrative practice before being codified in 1926. Reporting the income from installment sales as a portion of each payment received was accepted at least for some sales of real estate and for dealers in

231. *Id.*
232. Gen. Couns. Mem. 35,552 (Nov. 6, 1973); Garvey, Inc. v. United States, 726 F.2d 1569, 1574; Estate of Bell v. Commissioner, 60 T.C. 469, 479 (Simpson, J., dissenting).
233. *Id.*
234. *See generally* Midgley, *Federal Income Taxation of Private Annuitants*, 40 Geo. Wash. L. Rev. 679 (1972).
235. Pub. L. No. 96-471, 94 Stat. 2247 (1980).

personal property early in the history of the income tax.[236] After the Board of Tax Appeals invalidated use of the installment method for sellers of real estate and dealers in personal property in 1925,[237] Congress added section 212(d) to the Revenue Act of 1926, specifically permitting dealers and casual sellers of both real and personal property to elect the installment method.[238] The installment reporting rules, however, required that the contract or plan have a stated contract price, something that annuities measured by the life of an individual usually lack.[239] Further, the legislative history of the installment sale provisions made it quite clear that the installment method would only apply to sales on a conventional installment plan, not to other sales with deferred payments.[240]

Installment sales treatment allows a taxpayer to report the gain from a sale with deferred payments as the payments are received. Generally, the installment seller multiplies the amount of each principal payment received by the "gross profit percentage" for the sale and reports the resulting product as gain.[241] The seller determines the gross profit percentage for the transaction by dividing the gross profit by the contract price in the transaction.[242] The gross profit from a sale is determined by subtracting the taxpayer's adjusted basis[243] in the property sold from the selling price.[244] The seller computes the contract price of the transaction by subtracting the indebtedness

236. O.D. 181, 1 C.B. 76 (1919) permitted installment treatment in a sale of land where the seller could not discount or sell the promissory notes received "on account of the lack of credit of the buyers." The ruling required the taxpayer to allocate each payment between return of basis and gain. The ruling indicated that the seller would have had to report all of his gain in the year of the sale if the notes had been "the equivalent of cash." *See also* I.T. 1192, I-1 C.B. 78 (1922); Article 45, Regulations 45 (1920 ed.). I.T. 1227, I-1 C.B. 77 (1922) (construing the 1918 Revneue Act and explaining how dealers in personal property might apply the installment method).

237. Appeal of Six Hundred and Fifty West End Ave. Co., 2 B.T.A. 958 (1925); Appeal of Manomet Cranberry Co., 1 B.T.A. 706 (1925); Appeal of B.B. Todd, Inc., 1 B.T.A. 762 (1925).

238. Revenue Act of 1926, ch. 27 § 212(d), 44 Stat. 9 (1926).

239. Section 212(d) described the amount of income that the taxpayer should report as "that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the payment is completed bears to the total contract price." Revenue Act of 1926, § 212(d), ch. 27, 44 Stat. 9 (1926).

240. "Deferred-payment contracts other than installment contracts are not affected by the committee amendment." S. REP. No. 52, 69th Cong., 1st Sess. 19 (1926).

241. Temp. Treas. Reg. § 15A.453-1(b)(2)(i), T.D. 7768, 1981-1 C.B. 296.

242. *Id.*

243. Selling expenses and commissions are added to adjusted basis for the purpose of computing gross profit. *Id.* § 15A.453-1(b)(2)(v).

244. Selling price includes all consideration paid for the property, including encumbrances assumed by the buyer or to which the buyer took the property. *Id.* § 15A.453-1(b)(2)(ii).

assumed by the buyer or indebtedness to which the property was subject[245] from the selling price of the property.[246]

Transactions which did not qualify for installment treatment, and those in which the taxpayer did not choose to use the installment method, could be classified either as closed or open transactions. If the taxpayer received an obligation that was the equivalent of cash[247] or had a fair market value,[248] the taxpayer received closed transaction treatment. For the cash method taxpayer, closed transaction treatment meant using the sum of the cash received plus the fair market value of any obligations or other property received as the amount realized in the transaction.[249] The amount realized less the basis was the gain that the taxpayer reported as income in the year the property was sold.[250]

If the obligation received by the taxpayer did not have a fair market value, the taxpayer received open transaction treatment.[251] Open transaction treatment allowed taxpayers to recover their entire basis in the transferred property before reporting any gain.[252] Open transaction treatment gave the taxpayer the greatest possible tax deferral, and, of course, was much sought after.[253] The incentives for attempting to qualify any sale with any sort of contingent payment as an open transaction became even more compelling when one

245. The precise term under the current regulations for the indebtedness subtracted from selling price to compute contract price is "qualifying indebtedness." Qualifying indebtedness does not include "obligation[s] of the taxpayer incurred incident to the disposition of the property" or "obligation[s] functionally unrelated to the acquisition, holding, or operating of the property." *Id.* § 15A.453-1(b)(2)(iv).

246. *Id.* § 15A.453-1(b)(2)(iii).

247. Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961).

248. Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975).

249. Accrual method taxpayers report the amount of cash, plus the face value of obligations and the fair market value of other property received as the amount realized.

250. I.R.C. § 1001(a).

251. Burnet v. Logan, 283 U.S. 404 (1930).

252. *Id.*

253. Ginsburg, *Taxing the Sale for Future Payment*, 30 TAX L. REV. 471, 476 (1975). Attempting to qualify for open transaction treatment could have severe risk. As Professor Ginsburg states:

> Rules of sportive justice are engraved in the tax law, and special reward may be balanced by special risk. The Commissioner is committed to asserting that contingent obligations have currently ascertainable value, open transactions are closed and nonnegotiable notes and mere contractual obligations are the equivalent of cash. . . . When he prevails, the advantage to the revenue may extend far beyond accelerated recognition of part of the seller's total gain. Sportive justice here prevails when the property sold was a capital asset. . . . [I]f the buyer was an individual or an evidence of indebtedness is lacking, the seller's profit on future collection will be converted to ordinary income.

*Id.* at 477.

considers the alternatives. Since installment sales treatment, allowing taxpayers to spread their income over the length of the installment payments and also allowing them to recover a portion of their basis tax-free each year, was not available for any installment sale subject to contingencies,[254] the taxpayer's only alternative to open transaction treatment was being taxed on all of his gain in the year of the sale.

### *B. The Installment Sales Revision Act of 1980*

One of the objectives of the Installment Sales Revision Act of 1980 was to extend installment sale treatment and ratable recovery of gain to deferred payment sales that lacked a stated selling price or that were subject to contingencies.[255] The legislation reflects this intent by including in the definition of installment sale any "disposition of property where at least one payment is to be received after the close" of the year of disposition.[256] By making installment reporting available to sellers who legitimately used contingent prices or time periods on their sales contracts, Congress intended to ameliorate the Draconian treatment of closed transaction treatment for the deferred payment seller and induce sellers not to write "convoluted" sales agreements just to qualify for open transaction treatment.[257] In addition, the legislative history seems to indicate that Congress intended to make the open transaction unavailable in some transactions in which it had traditionally been available.[258]

The application of the installment sales rules to private annuities is somewhat problematical. Under the revised installment sales rules, an installment sale is defined as "a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs."[259] A private annuity received in exchange for appreciated property seems to fit within the definition, particularly in view of apparent congressional intent to expand

254. *In re* Steen, 509 F.2d 1398 (9th Cir. 1975); Gralapp v. United States, 458 F.2d 1158 (10th Cir. 1972).

255. H.R. Rep. No. 96-1042, *Installment Sales Revision Act of 1980*, 96th Cong., 2d Sess., 20-21 (1980).

256. I.R.C. § 453(b)(1). The Revision Act also required the Treasury Department to draft regulations providing for "ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained." I.R.C. § 453(j)(2).

257. H.R. Rep. No. 1042, 96th Cong., 2d Sess. 21 (1980).

258. *Id.* at 21. Goldberg, *Open Transaction Treatment for Deferred Payment Sales After the Installment Sales Act of 1980*, 34 Tax Law. 605, 614-616 (1981).

259. I.R.C. § 453(b)(1).

the reach of the installment sales rules. Both the Senate and House Reports on the Installment Sales Revision Act, however, contain footnotes stating that "the bill does not deal directly with" private annuity transactions.[260] The commentators have differed on whether the installment sales rules should apply to private annuities.[261] The Internal Revenue Service, however, reads section 453 and its legislative history as giving the government the right to establish guidelines on the dividing line between installment sales and annuities.[262] The Service has read the legislative history as follows:

> [W]e believe the statement in the committee reports referring specifically to private annuities confirms our belief that the legislation was not intended to subject private annuity transactions to the installment reporting rules.[263]

Therefore, the government seems to be unlikely to apply the installment sales rules to private annuities.

## V. The Impact of Self-Cancelling Installment Notes

At the same time that revision of the installment sales rules made installment sales more attractive, a Tax Court decision made available an economically attractive alternative to the private annuity, the self-cancelling installment note or SCIN.[264] In *Estate of Moss*, Moss had sold stock and real estate to the corporation that he had controlled in exchange for an installment promissory note that contained a provision that required that the note would be cancelled if the seller died before the end of the term of the note. The Internal Revenue

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260. H.R. Rep. No. 1042, 96th Cong., 2d Sess. 10, n.12 (1980); S. Rep. No. 1000, 96th Cong., 2d Sess. 12, n.12 (1980).

261. Professor Ginsburg has argued that the installment sales rules should not be applied to private annuities. Ginsburg, *Future Payment Sales After the 1980 Revision Act*, 39 Inst. on Fed. Tax'n § 43.09[4] (1981). Professors Manning and Hesch, on the other hand, have argued that installment sales regulations should be applied to private annuities, at least as an elected alternative to the statutory scheme under I.R.C. § 72. Manning and Hesch, *Private Annuities After the Installment Sales Revision Act of 1980*, 6 Rev. of Tax'n of Indivs. 20, 21 (1982).

262. Gen. Couns. Mem. 39053 (Nov. 7, 1983).

263. *Id.*

264. Estate of Moss, 74 T.C. 1239 (1980). The SCIN is sometimes also called the Death Terminating Installment Sale. *See* Roszak, *Installment Sales Terminating at Death Versus Private Annuities as Estate Planning Devices*, 59 J. Tax'n 20 (1983); Banoff & Hartz, *It's No Sin to SCIN! A Reply to Professor Blum on Self-Cancelling Installment Notes*, 60 Taxes 187 (1982); Blum, *Self-Cancelling Installment Notes—the New SCIN Game?*, 60 Taxes 183 (1982); Banoff & Hartz, *Sales of Property: Will Self-Cancelling Installment Notes Make Private Annuities Obsolete?*, 59 Taxes 499 (1981).

Service had argued that the cancellation provision made the notes includable in the gross estate of Moss at his death. The Court, analogizing the contract to a private annuity, held that the notes could not be included in the gross estate either under section 2033 or section 2036.[265]

Obviously, the self-cancelling installment note is economically very similar to a private annuity. In both cases, the seller is transferring property for a stream of payments. In both cases, the stream of payments ends upon the death of the seller. The major difference between the two types of transactions is that the liability of the buyer in the self-cancelling installment note is limited by a final date, while the annuity writer must continue to pay until the annuitant dies. To prevent abuse and to provide for a clear division, the Internal Revenue Service has limited the permissible time period for installment sales to the life expectancy of the seller. If the term of the note equals or exceeds the life expectancy of the seller, it will be classified as an annuity.[266]

The income tax consequences of self-cancelling installment notes are governed by the rules applicable to installment sales generally.[267] Therefore, each payment received by the seller is allocated between tax-free return of basis, gain from the sale, and interest.[268] Recapture income, however, will be recognized in the year of the disposition.[269] If the installment note does not provide for sufficient interest, a portion of each principal payment will be treated as interest under the imputed interest rules in the Code.[270] In addition, the installment sales rules provide that forgiven payments will be treated as though the seller had received the payments.[271] Also, under certain circumstances, the installment sales provisions restrict transactions involving related parties[272] and restrict the seller's ability to borrow against installment obligations.[273]

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265. Estate of Moss, 74 T.C. 1239, 1244-1249.
266. Rev. Rul. 86-72, *explained in* Gen. Couns. Mem. 39503 (May 7, 1986).
267. *Roszak, supra* note 264, at 23. This position seems to be implicit in the discussion of SCIN's in Gen. Couns. Mem. 39503 (May 7, 1986).
268. Gen. Couns. Mem. 39503 (May 7, 1986).
269. I.R.C. § 453(i).
270. I.R.C. §§ 483, 1271-1274. These rules generally apply to any disposition of property where the value of the property exceeds $10,000.
271. I.R.C. § 453B(f).
272. If the seller sells property to a related party, and if the related party resells the property within two years from the date of the original installment sale, the proceeds received by the related party on the second sale will be treated as received by the installment seller. I.R.C. § 453(e)(1). If the property sold by the installment seller consists of marketable securities, any resale by the related party will be attributed to the installment seller. I.R.C. § 453(e)(2).
273. *See* I.R.C. § 453C.

The use of death terminating installment sales should reinforce the trend toward using a ratable recovery approach in taxing the gain in private annuity transactions. The private annuity is economically very similar to the death terminating installment sale. The installment sale rules applicable to the death terminating installment sale produces a ratable recovery of gain. It is an axiom of tax policy to try to tax similar transactions in a similar way. Thus, the private annuity should be taxed under a ratable recovery approach as well.

## VI. Current State of the Law of Private Annuities

The income tax consequences of private annuities entered into today are unsettled, particularly for annuitants. If the parties enter into an unsecured annuity, the safest approach for reporting the annuitant's gain is to prorate the gain over the life expectancy of the annuitant under section 72.[274] Because the ratable recovery approach has been adopted in recent government rulings,[275] it is more likely than the open transaction approach to receive a favorable audit report. Even under this approach, however, it is unclear whether the basis of the property transferred in exchange for the annuity is the annuitant's investment in the contract,[276] or whether the fair market value of the annuity is the investment in the contract.[277] If the matter of the gain recognition were litigated in the Tax Court, it is unclear what the court might decide. The court might apply the open transaction principles of the *Lloyd* decision[278] which has never been overruled. While the Tax Court narrowly refused to adopt a ratable recovery approach in the *Bell* case, a majority of the current court might adopt a ratable gain recognition approach.[279] It is even conceivable that a court, finding that the terms of a private annuity fit the definition of an installment sale, would try to apply installment sales principles to the transaction.[280]

It seems well established that annuity writers do not receive an interest deduction,[281] and that an annuity writer's basis will generally

274. Rev. Rul. 69-74, 1969-1 C.B. 43; Garvey, Inc. v. United States, 1 Cl. Ct. 108 (1983); Treas. Reg. § 1.1011-2, example (8) (1972). *See supra* notes 183 & 195 and accompanying text.
275. Rev. Rul. 69-74, 1969-1 C.B. 43; Treas. Reg. § 1.1011-2(c), example (8) (1972). *See supra* notes 183 & 195 and accompanying text.
276. Rev. Rul. 69-74, 1969-1 C.B. 43; Garvey, Inc. v. United States, Cl. Ct. 108 (1983).
277. Treas. Reg. § 1.1011-2(c), example 8 (1972).
278. Lloyd v. Commissioner, 33 B.T.A. 903 (1936), *nonacq.* XV-2 C.B. 39 (1936), *nonacq. withdrawn and acq.* 1950-2 C.B. 3.
279. Estate of Bell, 60 T.C. 469, 479 (Simpson, J., dissenting.)
280. *Manning and Hesch, supra* note 10.
281. *See supra* notes 150-160 and accompanying text.

be treated as the sum of the payments made to the annuitant,[282] but there is authority to the contrary.[283] It is also clear that some of the differences in tax treatment between the death terminating installment sales and private annuities, particularly the denial of interest deductions for writers of private annuities, create differential tax treatment for economically very similar transactions.[284] A careful reconsideration of the rules governing private annuities is clearly in order.

## VI. Proposal for Taxation of Private Annuities

Revising the tax treatment of private annuities will probably not be the subject of Congressional action in the near future.[285] The private annuity is economically very similar to several other transactions, from the split purchase of life interests and remainders to the death terminating installment sale.[286] To rationalize the tax treatment of all of these economically similar instruments and reduce or eliminate the differences in tax treatment among them, however, would require a number of amendments to the Code.[287] Making significant changes to the Code for the sake of reform seems unlikely in the present legislative climate. Politically, the support for tax reform, even reforms intended to benefit large numbers of taxpayers, is like many of the creeks in the Western Great Plains, completely dry most of the time, and very shallow and slow moving when the current is running. The small but organized opposition usually has a stronger voice and can prevent reform easily.[288] Moreover, since the Tax Reform Act of 1986 and its subsequent technical corrections, the political force for tax reform is largely spent, and the Congressional focus is on larger concerns and on raising money to reduce the deficit.[289]

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282. *See* Rev. Rul. 55-119, 1955-1 C.B. 352. *See also supra* notes 131-146 and accompanying text.
283. *See, e.g.*, Commissioner v. John C. Moore Corp., 42 F.2d 186 (2d Cir. 1930).
284. Banoff & Hartz, *Self-Cancelling Installment Notes: New I.R.S. Rulings Expand Opportunities*, 65 J. TAX'N 146 (1986).
285. On the hazards of predicting Congressional action, see Verdier, *A Framework for Predicting Congressional Action*, 41 TAX NOTES 435 (1988).
286. Lane, *Intra-Family Sales: Toward a Uniform Tax Treatment*, 41 TAX LAW. 279 (Winter 1988).
287. *Id.* at 322-323.
288. *See generally* J. BIRNBAUM & A. MURRAY, SHOWDOWN AT GUCCI GULCH (1987). Using James Verdier's *Framework*, the private annuity problem will generate insufficient excitement for reform, the solutions have received insufficient attention to drive a reform effort, and the issue offers little to gain for the politicians involved. *Verdier, supra* note 285, at 436-441. Therefore, it seems an unlikely candidate for congressional action in the near future.
289. H.R. CONF. REP. No. 99-841, *Tax Reform Act of 1986—Conference Report to*

Therefore, the income tax rules applicable to private annuities should be revised through rulings or regulations. While conforming the income tax treatment of private annuities completely to the economic and actuarial principles that underlie them is impossible under the current statute,[290] significant improvements can be made. The gain in the annuitant's appreciated property exchanged for a private annuity should be recovered ratably over the annuitant's life expectancy, with adjustments for mortality gains and losses.[291] In recognition of the notions of the time value of money incorporated in the Code in the 1980's, the ordinary income portion of private annuities should be treated as interest paid by annuity writers.[292] The basis of annuity writers in property acquired in exchange for private annuities should recognize the interest element in annuities and should produce more certain results.[293] These changes in the income tax treatment of private annuities will also reduce the differences in tax treatment between private annuities and the instrument most often compared with private annuities, installment sales terminating at the death of the seller.[294] Revised rulings or regulations on the income tax consequences of private annuities under the current statutory scheme should incorporate the following principles:

### A. *Ratable Recognition of Gain*

1. The principles of section 72, the annuity rules, rather than the principles of section 453, the installment sales provisions, should

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*Accompany H.R. 3838*, 99th Cong., 2d Sess. II-838 (1986) reports a Senate sponsored sense of the Congress resolution that "the provisions of the Internal Revenue Code that are added or amended in the current legislation should remain unchanged for a period of at least five years from the date of enactment." While Congress has passed two significant tax bills since the 1986 Act, DEFRA and TAMRA, these have largely been in the nature of tinkering to make the provisions of the 1986 reform work better. The tax bills currently under study in the Congress involve raising revenue to help to control the budget deficit, on attempting to make the fringe-benefit non-discrimination rules of section 89 workable, and returning preferred treatment for capital gains to the Code (a provision advocated because it can, allegedly, raise revenue). Rosenthal, *Bentsen to Treasury: Take a (Useful) Stand on Section 89*, 43 TAX NOTES 779 (1989); Jones, *JCT, Archer Moving Ahead on Capital Gains Proposal*, 43 TAX NOTES 1303 (1989).

290. *See Lane, supra* note 286. The current annuity rules in I.R.C. section 72 treat all payments under an annuity as consisting of the same proportion of principal and interest. In reality, the amount of interest in the payments decreases over the term of the annuity and the principal element increases. *See supra* note 70.

291. *See infra* notes 295-324 and accompanying text.

292. *See infra* notes 325-335 and accompanying text.

293. *See infra* notes 336-351 and accompanying text.

294. *See, e.g.*, Roszak, *Installment Sales Terminating at Death Versus Private Annuities as Estate Planning Devices*, 59 J. TAX'N 20 (1983).

govern the recognition of annuitant's gain in appreciated property exchanged for a private annuity.[295]

Ratable recovery is the soundest approach to recognizing the annuitant's gain in her appreciated property. Open transaction treatment, as used in the *Lloyd* case, permits the annuitant unjustified tax deferral, and, if the annuitant dies prematurely, may permit all, or a substantial portion of the annuitant's gain to go untaxed.[296] In contrast, recognizing all of the annuitant's gain upon entering into the annuity—closed transaction treatment—may leave the annuitant with a large tax liability and insufficient funds available to pay the tax. Ratable recovery prevents annuitants from having liquidity problems because it enables annuitants to match their tax liability with the receipt of annuity proceeds.[297]

Both on the grounds of narrow legislative history and tax policy, the annuity provisions of section 72, rather than the installment sales provisions of section 453, should govern the gain recognition consequences of private annuities. Section 72 is designed specifically to govern transactions in which the amount that the taxpayer will receive depends on the taxpayer's lifespan. Within the terms of the agreement negotiated by the parties, specific rules have been developed to govern return of the annuitant's investment, to tax the interest element inherent in annuities, and to deal with the mortality gains and losses inherent in annuities.[298] In addition, supplementary rules are available to deal with provisions, such as refund features, not usually included in private annuities.[299] Developing rules to govern gain recognition for contingent payment sales, on the other hand, has proven to be a very difficult problem.[300]

While the broad definition of the installment sale in section 453 arguably includes private annuities, the legislative history seems to indicate that Congress did not intend that the installment sale rules be extended to them.[301] Therefore, any ruling or regulation applying

295. Gen. Couns. Mem. 39,503 (May 7, 1986). Ginsburg, *Future Payment Sales After the 1980 Revision Act*, 39 Inst. on Fed. Tax'n § 43.09 (1981). *But see Manning and Hesch supra* note 10.

296. Midgley, *Federal Income Taxation of Private Annuitants*, 40 Geo. Wash. L. Rev. 679, 705 (1972).

297. H.R. Rep. No. 1042, *Installment Sales Revision Act of 1980*, 96th Cong., 2d Sess. 5 (1980).

298. I.R.C. § 72(b).

299. I.R.C. § 72(c)(2).

300. Ginsburg, *Taxing Future Payments, supra* note 10, at 474-478.

301. *See supra* notes 256-262 and accompanying text.

the installment sales rules to private annuities could be easily challenged as inconsistent with legislative intent.

Applying the annuity provisions rather than the installment sales provisions of the Code to the timing of gain or loss recognition in private annuities leaves private annuities as a possible avenue for escaping some difficult strictures in the installment sales rules. For example, the installment sales provisions specifically provide that ordinary income from recaptures will be recognized immediately upon the disposition.[302] The same result should obtain under section 72, but the result would have to be inferred from the absence of a special provision requiring ratable recognition in the recapture provisions.[303] The absence of specific rules governing the disposition of private annuity contracts, rules analogous to section 453B,[304] may not be a serious problem because of the difference between an annuity and an installment sales agreement. It is unlikely that an outsider would be willing to assume the open-ended obligation imposed upon the annuity writer.

Applying section 453B to private annuities might even produce expensive anomalies for annuitants. The death of the annuitant before the end of her life expectancy and the consequent termination of payments might be treated as the "disposition" of "an installment obligation" (the annuity). If so, section 453B would treat the seller as receiving the remaining payments, including, perhaps, the remaining payments over annuitant's life expectancy, on the date of death.[305] If the annuity payments that would have been payable over the annuitant's remaining life expectancy were considered remaining payments, the annuitant would have a substantial, unexpected tax liability.[306]

The congressional revision of the installment sales rules in the 1980's has included the enactment of provisions to prevent taxpayers from taking undue advantage of the installment sales rules. These anti-abuse provisions include rules to inhibit installment sellers from borrowing against installment obligations[307] and to prevent purchasers

302. I.R.C. § 453(i).
303. *See, e.g.*, I.R.C. § 453(a)(1), (b).
304. I.R.C. § 453B provides generally that all unrecognized gain from an installment sale shall be recognized when the obligee disposes of the installment obligation.
305. *See* Rev. Rul. 86-72, 1986-1 C.B. 253.
306. *Ginsburg, supra* note 295 at § 43.09[4][a]; Manning & Hesch, *supra* note 10 at 35-6.
307. I.R.C. § 453A(a)(1) generally provides that installment sellers pay interest to the government on the amount of tax liability that the seller has deferred through use of the

of property from disposing of the property for cash when the purchaser acquired the property from a related party in an installment sale.[308] The annuity rules do not contain such anti-abuse provisions. The absence of anti-abuse safeguards in the annuity rules might provide opportunities for taxpayer abuse. A small amount of taxpayer abuse, however, may be the inevitable result of excluding private annuities from the installment sales provisions. In addition, if using the private annuity rules to avoid restrictions in the installment sales provisions becomes a problem, the broad regulatory authority given to the Treasury under the installment sales rules[309] might be used to prevent abuse.

*Revenue Ruling 69-74*,[310] the ruling currently governing the tax consequences to annuitants from private annuities, should be revised to conform to the current provisions of section 72. The ruling's oft-criticized requirement that the annuitant's basis in the property exchanged for an annuity be treated as the annuitant's investment in the contract must be retained, because the approach adopted in the Revenue Ruling is completely consistent with the statutory scheme of section 72.[311] Section 72 requires all annuitants to pro-rate their investment in the contract over their life expectancy.[312] Treating the annuitant's basis as the investment in the contract provides a statutory foundation for pro-rating the annuitant's gain in the property exchanged for the annuity over the annuitant's life expectancy.[313] Using the fair market value of the property as the investment in the contract,[314] on the other hand, does not provide such a solid statutory foundation because there is no statutory provision requiring gain

installment sales provisions. This rule applies to obligations in which the selling price exceeds $150,000, and where the total face amount of the seller's outstanding installment obligations exceeds $5 million. I.R.C. § 453A(b). Section 453A(a)(2) treats the pledging of an installment obligation as a disposition of the obligation. I.R.C. § 453A(a)(2).

308. I.R.C. § 453(e). This provision applies when the buyer who is related to the seller in an installment sale disposes of the property that was the subject of the installment sale within two years of the installment sale. *Id.* § 453(e)(1), (e)(2). If the buyer then resells the property, the consideration received by the buyer will be treated as a payment received by the seller. *Id.* § 453(e)(1).

309. I.R.C. §§ 453(j), 453A(e).

310. Rev. Rul. 69-74, 1969-1 C.B. 43.

311. Garvey, Inc. v. United States, 1 Cl. Ct. 108, 125-26 (1983).

312. I.R.C. § 72(b)(1).

313. Garvey, Inc. v. United States, 1 Cl. Ct. 108, 125-26. For a further discussion of this point, see *supra* notes 218-233 and accompanying text.

314. 212 Corp. v. Commissioner, 70 T.C. 788 (1978); Estate of Bell v. Commissioner, 60 T.C. 469 (1973). For cases decided under provisions of the 1939 code, see Hill's Estate v. Maloney, 58 F. Supp. 164 (D.N.J. 1944); de Canizares v. Commissioner, 32 T.C. 345 (1959).

within the "investment in the contract" to be recognized.[315] Defining the investment in the contract as the fair market value of the property arguably permits the gain inherent in the transferred property to escape taxation completely.[316]

*Revenue Ruling 69-74* should also be up-dated to conform to the new treatment of mortality gains and losses in section 72.[317] In 1986, Congress amended section 72 to provide for individualized treatment of mortality gains and losses in annuities. Annuitants who die before reaching their life expectancies receive a deduction for unrecovered investment to the contract.[318] If the annuitant dies before exhausting her life expectancy, the remaining basis in the transferred property should be deducted on the annuitant's final income tax return as a loss.[319] In cases of annuities purchased for cash, the annuitant receives an ordinary deduction, because the annuitant has reported ordinary income.[320] In a private annuity, the annuitant reports both ordinary income and capital gain. The character of the deduction in a private annuity received for appreciated property should be, in part, ordinary income, and in part, determined by the character of the property exchanged for the private annuity.[321] If the annuitant exchanged a capital asset held for more than a year for the annuity, a portion of the deduction for unrecovered investment in the contract should be a long term capital loss.[322] If the annuitant outlives her life expectancy, she loses the benefit of the exclusion, and all of the annuity payments are then ordinary income.[323]

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315. The dissenters in the *Estate of Bell* case would have treated the fair market value of the transferred property as the investment in the contract and would have prorated the gain over the annuitant's life expectancy under the general principles of section 72. *Estate of Bell*, 60 T.C. 469, 479 (Simpson, J., dissenting). General principles, however, do not amount to a solid statutory foundation.

316. Garvey, Inc. v. United States, 1 Cl. Ct. 108, 125 (1983).

317. I.R.C. § 72(b)(2), (b)(3).

318. I.R.C. § 72(b)(3).

319. *Id.* Again, using the fair market value of the property transferred in exchange for the annuity as the "investment in the contract" would pose difficult problems for determining the amount and character of the deduction to be claimed by the annuitant. *See supra* note 298 and accompanying text.

320. I.R.C. § 72(b)(3).

321. *See generally* Arrowsmith v. Commissioner, 344 U.S. 6 (1952). The portion of the deduction attributable to ordinary income could be determined by the following formula: OI* Unrecovered Investment in the Contract/Payment where OI is the amount of ordinary income in each annuity payment, and Payment is the amount of each annuity payment. The character of the remainder of the deduction would be determined by the character of the gain on the asset exchanged for the private annuity.

322. *Id.*

323. I.R.C. § 72(b)(2).

The distinction in tax treatment between secured and unsecured annuities should be abolished. The cases requiring all of the gain in property to be recognized immediately upon an exchange for a secured private annuity attempted to limit the sweep of the *Lloyd* case's open transaction treatment.[324] Open transactions and closed transactions are conceptually foreign to the application of section 72 to private annuities in *Revenue Ruling 69-74.* Secured annuities are subject to the same mortality contingencies that unsecured annuities are, and both should be treated under section 72 for all purposes. In addition, treating secured annuities as a closed transaction treats them as a sale or exchange of property. As a sale or exchange of property, rather than a private annuity, the secured private annuity could arguably be treated as an installment sale under section 453, creating an undesirable confusion in the tax law applicable to private annuities.

### B. *Interest Deduction for Annuity Writers*

The ordinary income portion of private annuities should be treated as interest, deductible for the annuity writer under Internal Revenue Code section 163.

Commentators have long urged the government and the courts to recognize the interest element in private annuities.[325] The majority of cases involving private annuities, however, have consistently rejected treating the ordinary income portion of private annuities as interest.[326] The usual reason given is that annuities lack a stated principal sum and that any computation of interest would have to be based upon "some esoteric concept derived from subtle and theoretic [sic] analysis"[327] such as present value analysis.

Economically, however, the ordinary income portion of an annuity is interest. It is based upon the time value of the money invested to obtain the annuity.[328] The level of economic sophistication evidenced in the federal tax law is much greater than it was in the 1930's. Reversing earlier holdings that there was no gift involved in interest-

324. *See* Note, *Private Annuities—Capital Gain Treatment for Private Annuities—212 Corporation v. Commissioner,* 15 WAKE FOREST L. REV. 724, 733-734 (1979).
325. *See, e.g.,* Galvin, *Income Tax Consequences of Agreements Involving Noncommercial Annuities,* 29 TEX. L. REV. 469, 491-497 (1951).
326. *See supra* notes 149-161 and accompanying text.
327. Old Colony R.R. Co. v. Commissioner, 284 U.S. 552, 561 (1932).
328. Johnson, *Special Commentary II, supra* note 29, at 238-39 (1987).

free demand loans, the Supreme Court used time value of money concepts to find a financial benefit in interest-free loans.[329] Concepts of the time value of money and present value have been incorporated wholesale in the Internal Revenue Code in the 1980's.[330] While annuities are specifically excluded from the operation of the imputed interest rules,[331] this does not mean that Congress has not recognized the "interest" element of annuities. Congress has probably just left the computation of the ordinary income element of annuities to the annuity tables.[332] In 1988, Congress enacted a provision requiring the Treasury Department to publish annuity tables monthly based upon current interest rates,[333] a clear recognition of the existence of an interest element in annuities. In view of the pervasive incorporation of the concepts of the time value of money in the tax law, the writers of private annuities should be able to treat the ordinary income element of an annunity as interest, subject to the restrictions imposed upon the interest deduction under section 163.[334]

Once annuitants have outlived their life expectancies, however, the entire payment received by annuitants is ordinary income. Treating the entire payment as deductible interest after annuitants have attained their life expectancies would give the annuity writers an excessive benefit. Therefore, a suggested method for annuity writers to use in allocating payments between principal and interest after the expiration of annuitants, life expectancies is described below in connection with determining the annuity writer's basis in the acquired property.[335]

### *C. Basis of Acquired Property*

The basis of property acquired in exchange for a private annuity is the most difficult issue involving private annuities. Because the number of years that the annuitant will live is uncertain, it is impossible to establish the amount that the annuity writer has paid for the property acquired until the annuitant has died.

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329. Dickman v. Commissioner, 465 U.S. 330, 336 (1984).
330. *See* I.R.C. §§ 483, 1271-1288, 7872.
331. I.R.C. §§ 1275(a)(1)(B); *id.* § 483(c)(3).
332. *Manning & Hesch, supra* note 10 at 38.
333. I.R.C, § 7520 (1989).
334. *See, e.g.*, I.R.C. § 163(d).
335. *See infra* notes 340-351 and accompanying text.

*Revenue Ruling 55-119*, the source of the current rules for basis of property acquired in exchange for a private annuity, assumes that all payments made by the annuity writer under the annuity contract are capital expenditures.[336] It recognizes no deductible interest element in annuity payments. *Revenue Ruling 55-119* should be replaced as a part of the comprehensive revision of the private annuity rules advocated by this article. The replacement ruling for *Revenue Ruling 55-119* would have to treat only the nondeductible, principal, portion of the annuity writer's payment as includible in the basis of the property. The fundamental approach taken by *Revenue Ruling 55-119*, however, that the basis of property acquired in exchange for an annuity should be based, whenever possible, on the amount of nondeductible payments made by the annuity writer, is fundamentally sound and should be retained.[337]

A revised Revenue Ruling on basis should treat the present value of the annuity as the basis of the property for depreciation purposes.[338] If the annuity writer sells the property during the life of the annuitant, the basis for the annuity writer should be the total of the principal portion of the annuity payments made before the disposition. A loss deduction should be recognized by the annuity writer after the annuitant has died, and the principal amount paid by the annuity writer is certain.[339]

A difficult problem arises in situations in which the annuitant outlives his or her life expectancy. While the annuitant must treat the entire amount of the annuity payment as ordinary income, this result occurs because the annuitant has recovered the entire amount invested in the contract.[340] Allowing the annuity writer to deduct the annuity payments in full after the annuitant has outlived her life expectancy allows an unreasonably large deduction. Instead, annuity payments made to the annuitant after the annuitant has outlived the annuitant's original life expectancy should be allocated between principal and income in a method that recognizes the time value of money and life expectancy. When the private annuitants survive their original life expectancies, the annuity writer should treat the transaction as though a new annuity agreement had been reached with

336. Rev. Rul. 55-119, 1955-1 C.B. 352, 354.
337. *Id.* at 354.
338. *See id.* at 353 (utilizing this same treatment).
339. This approach is similar to that used in point 3 of Rev. Rul. 55-119, 1955-1 C.B. 352, at 354.
340. I.R.C. § 72(b)(2).

the annuitant, using the payment schedule under the annuity contract and the annuitant's life expectancy as of the end of the originally determined life expectancy.[341] The present value of this "constructive annuity" at the date of the redetermination will be treated as the "investment in the contract" for the purpose of determining the principal portion of each annuity payment. The remainder of each payment will be considered interest. All payments received after the end of their original life expectancies will be considered ordinary income for annuitants.

An example to illustrate the application of the principles of the proposed rulings may be helpful. Aunt Anne, age fifty-nine, transfers an income-producing capital asset with a value of $75,675 and a basis of $20,000 to her niece, Nettie, in exchange for an annuity of $10,000 per year to be paid at the end of each year. According to the gift tax regulations,[342] the value of the annuity is $75,675, and so there is no gift involved in the transfer. Aunt Anne's expected return factor, according to the tables for single-life annuities under section 72,[343] is 25.0, and her expected return is $250,000.[344] Using Anne's basis in her property as her investment in the contract, she will be able to exclude $800 from each payment as a return of her basis.[345] Anne's capital gain is the fair market value of the annuity, $75,675, less her basis in her property, $20,000, or $55,675.[346] The capital gain will be prorated over Anne's life expectancy, 25.0 years, for an annual capital gain of approximately $2,227.00.[347] The remainder of each payment, $6,973, is ordinary income.

If Anne dies after ten years, she will have recovered $8,000 of basis. She will receive a $12,000 capital loss for her unrecovered

341. Using the annuitant's life expectancy at a date later than the date of the original annuity contract is similar to a concept used in Rev. Rul. 55-119, 1955-1 C.B. 352, 355. In the Revenue Ruling, the basis of acquired property for gain purposes for an annuity writer who sells the property during the life of the annuitant is the total amount paid under the annuity contract as of the date of sale, plus the value of the expected payments according to the life expectancy of the annuitant as of the date that the property was sold. Rev. Rul. 55-119, 1955-1, C.B. 352, 355.

342. Treas. Reg. 25.2512-5(f), Table A, T.D. 7955, 1984-1 C.B. 40, 86.

343. Treas. Reg. 1.72-9, Table V, T.D. 8115, 1987-1 C.B. 22, 39.

344. $10,000, the annual payment under the annuity, multiplied by 25.0, the expected return multiple.

345. Treas. Reg. § 1.72-4(a)(1)(i), T.D. 6211, 1956-2 C.B. 29, 36 provides for computing an exclusion ratio of I/ER, where I is investment in the contract and ER is expected return. Here that ratio is $20,000/$250,000, or 8%. Multiplying the exclusion ratio by the annual payment yields a tax-free return of capital of $800.

346. *See* I.R.C. § 1001(a).

347. *See* Rev. Rul. 69-74, 1969-1 C.B. 43, 44. Anne must divide the gain, $55,675, by her life expectancy, 25.0, for an annual gain of $2,227 per year.

basis. If Anne lives beyond her life expectancy, she will have $10,000 of ordinary income per year.

Nettie will be treated as paying interest of $6,973 each year during Anne's life expectancy. Nettie's interest deduction may be limited, because the interest is probably investment interest.[348] If Nettie disposes of the stock during Anne's life, her basis will be the sum of the payments she has made to the date of the sale. At Anne's death, Nettie's basis in the stock will be finally determined. If Anne dies before reaching her life expectancy, Nettie will have to report a capital gain. If Anne dies after exceeding her life expectancy, Nettie will have to report a capital loss.

If Anne reaches age eighty-four, her life expectancy, then Nettie must figure the tax consequences of future payments. The constructive annuity will be figured as though Nettie had entered into a $10,000 per year annuity transaction with Anne at the time Anne completed the life expectancy on the first annuity. Anne has a life expectancy of 7.4 years.[349] The value of an annuity of $10,000 per year on the life of an eighty-four-year-old individual is $36,998.[350] Therefore, Nettie will treat $4,999.73 of each payment as return of capital and $5,000.27 as interest.[351]

## VIII. Conclusion

The income tax treatment of private annuities, in which an individual annuitant transfers appreciated property to another individual in exchange for a single life annuity, has followed a tortuous path. The actuarial principles behind annuities, that each annuity payment consists of return of capital and interest, were well established by the time the income tax came into being in 1913. The early income tax, however, ignored actuarial science and adopted a simple return of capital approach, permitting annuitants to recover all of their premiums tax-free before having to report gross income. The income

348. *See* § 163(d).
349. Treas. Reg. 1.72-9, Table V, T.D. 8115, 1987-1 C.B. 22, 39.
350. Treas. Reg. 25.2512-5(f), Table A, T.D. 7955, 1984-1 C.B. 40, 86.
351. The expected return in this case is 7.4 times $10,000, or $74,000. The investment in the contract of this constructive contract is $36,998. Therefore, the exclusion ratio is $36,998/$74,000 or 49.9973%. Multiplying the exclusion ratio by the annual payment makes $4,999.73 a "principal" payment for each annuity payment, leaving $5,000.27 as "interest." These amounts, of course, would be rounded off to $5,000 interest and $5,000 principal. The fact that the interest and principal payments are equal is a coincidence.

tax treatment of private annuitants, like the income tax treatment of annuitants generally, permitted annuitants to recover their basis completely before reporting any income. The income tax treatment of annuity writers also ignored the interest portion of annuity payments, treating all annuity payments as capital expenditures.

A more realistic view of commercial annuities came into the Code in 1954 with the adoption of section 72, requiring annuitants to prorate their investment in the contract over their life expectancy. But Congress failed to establish rules governing private annuities and failed to deal with mortality gains and losses. In *Revenue Ruling 69-72*, the Internal Revenue Service finally began to apply the gain proration principles of section 72 to the appreciated property exchanged for private annuities. The gain proration concepts of the ruling, however, have not been universally adopted by the courts. Also, the tax treatment of annuity writers still fails to recognize the interest component of private annuity payments.

Changes made in the tax laws and in estate planning techniques in the 1980's require a re-examination of the Service's rulings governing private annuity transactions. The revised installment sales rules, first enacted in 1980, arguably apply to annuity transactions. Estate planners developed similar transactions, particularly the installment sale terminating at the death of the seller, which were economically similar to the private annuity but which had income tax consequences very different from those of the private annuity. Congress incorporated concepts of present value and imputed interest wholesale into the Code in 1982 and 1984 and revised the annuity income tax rules to recognize mortality gains and losses in 1986.

To conform to the Code's recent revisions and to reduce the discrepancies between private annuities and death terminating installment sales, the government should revise the Revenue Rulings governing the income tax consequences of private annuities. The basic approach of *Revenue Ruling 69-74*, rather than the installment sales rules, should determine the tax treatment of annuitants. The ruling, however, should be revised to permit annuitants deductions for mortality losses. The ordinary income portion of annuity payments should be treated as interest for annuity writers. The rules governing basis in property acquired for private annuities should recognize the interest element of private annuities and should provide a detailed scheme for computing interest and principal portions of payments made to annuitants who out-live their life expectancies.