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The New Case for Private Annuities

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INTRODUCTION

With the promulgation of Rev. Rul. 69-74,[1] many of the advantages of a private annuity[2] were curtailed because of the holdings that (1) capital gain was recognized on the transaction before the recoupment of basis, and (2) the investment in the contract was limited to the adjusted basis of the appreciated property contributed thus reducing the lifetime exclusion ratio.[3] Because of these disadvantages and the fact that the three and one-half percent annuity tables[4] were so outdated, many estate planners have felt that the private annuity lost some of its lustre.

However, in the *Federal Register* for July 3, 1970, the Internal Revenue Service published proposed regulations amending Treas. Reg. § 20.2031-7 (1958) to provide new tables to be used in the valuation of annuities, life estates, terms of years, remainders, and reversions.[5] These proposed regulations were adopted by T. R. 7077,[6] thus incorporating the new tables for transfers occurring after December 31, 1971. According to Rev. Rul. 69-74,[7] the estate-gift tax tables are the tables to be used to value private annuities. The tables may be found in Treas. Reg. § 20.2031-10 (1970) and Treas. Reg. § 25.2512-9 (1970).

Consequently, it is now necessary for taxpayers and their counsel to re-examine the economic and tax advantages and disadvantages of a private annuity. The purpose of this article is to show how, in

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1 1969-1 CUM. BULL. 43.

2 Private annuities will be defined in depth later in the article.

3 Estate of Hill v. Maloney, 58 F. Supp. 164 (D.N.J. 1944), held that the exclusion continues throughout the life of the annuitant, even after his basis is recouped.

4 *See* Treas. Reg. § 20.2031-7 (1958).

5 Treas. Reg. § 20.2031-7 (1958); Treas. Reg. § 20.2031-10 (1970); Treas. Reg. § 25.2512-5 (1970).

6 1970-2 CUM. BULL. 183.

7 1969-1 CUM. BULL. 43.

light of the new tables, one can gain maximum tax and economic advantage from private annuities.

The approach to be used will be a historical one. This will enable one to see the gradual changes in the law and also to see the income, gift and estate tax consequences starting from the simplest transaction and ending with one of the more complex estate planning usages of a private annuity. Following the discussion on the two major approaches to private annuities, there will be a summary of the economic and tax consequences. The final section of the paper will be devoted to a hypothetical plan which will maximize the advantages and minimize the disadvantages.

I. DEFINITION OF A PRIVATE ANNUITY

The private or non-commercial annuity is an arrangement whereby an individual (the transferor) transfers cash or other property to another individual, or to a corporation, or to some other entity (the transferee), which transferee is not in the business of selling annuities, in exchange for the transferee's promise to make periodic payments in fixed amounts to the transferor for the remainder of the transferor's life. A private annuity is not, however, the same as a life estate. A private annuity provides a set-guaranteed return lasting for life; while a life estate provides only so much income as is actually earned for life. Thus in a life estate, if the property earns more money than the fixed payments in a private annuity, the transferor gets more, and conversely, if the property earns less, the transferor gets less. A retained life estate is included in one's estate under Internal Revenue Code of 1954 (hereinafter IRC), § 2036,[8] while a private annuity is an arm's length transaction which generally does not require inclusion under Section 2036.[9]

Annuities are classified according to their modes of payment (fixed or variable), the nature of the promisor (commercial, quasi-commercial or private party), or the usages to which they are put

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[8] INT. REV. CODE of 1954, § 2036(a) provides that "the value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life . . . (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

[9] INT. REV. CODE of 1954, § 2036 excepts a bona fide transaction for full and adequate consideration.

(pension, redemption or inter-family exchange). What we are dealing with in this paper is a fixed payment private annuity from a non-commercial source which does not issue such policies from time to time.

We are not covering the variable annuity,[10] the payments from which are keyed to appreciation in a common trust fund of equity investments. This device is more common in pension fund and redemption plans than in inter-family exchanges because of the necessity of maintaining a substantial portfolio of stock and bonds.

We are also not dealing with a commercial annuity. Commercial annuity purchases require cash, while property is used to purchase private annuities. Standard actuarial tables govern commercial annuities, while a gift may be involved in a less than arm's length family transaction. The transferee in a private annuity is never subject to state insurance law restrictions on investments and reserves as is a commercial issuer of annuities. An annuity company writes enough policies to obtain a set actuarial risk while a family does not.

In the past few years educational and charitable institutions have been issuing semi-private annuities.[11] They do so on a regular basis, yet they receive property rather than cash. These "hybrids" are treated under a distinct set of rules by the Treasury, *i.e.*, closed transactions producing immediate gains[12] with the annuity element being valued through the use of the standard annuity tables.[13] As we shall see later, the Treasury does not follow the same practice as far as taxing income from wholly private annuities.

II. HISTORY OF THE INCOME TAX CONSEQUENCES OF PRIVATE ANNUITIES UNDER THE LAW PRIOR TO REV. RUL. 69-74

Prior to Rev. Rul. 69-74,[14] the transferor annuitant was treated as receiving an unsecured promise from a private individual that was incapable of valuation.[15] Under the principle of *Burnet v.*

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10 For an excellent discussion of variable annuities, *see* Vernava, *Tax Planning for the Not So Rich; Variable and Private Annuities*, 11 WM. & MARY L. REV. 1 (1969).

11 *Id.*

12 Rev. Rul. 136, 1962-2 CUM. BULL. 12.

13 Rev. Bull. 137, 1962-2 CUM. BULL. 28.

14 1969-1 CUM. BULL. 43.

15 Rev. Rul. 402, 1958-2 CUM. BULL. 15, takes the position that only in rare and unusual circumstances is a promise to pay incapable of valuation. Private annuities are one of those rare situations.

Logan[16] the transaction was considered open rather than closed at the time the annuitant entered into the contract.

In *Logan* the Supreme Court held that where property is exchanged for the promise to pay an uncertain amount in the future and where immediate valuation of the promise is impossible, then the transferor can recoup his basis for the property before reporting any payments as income, and after the payments equal the transferor's basis, all subsequent payments for the capital asset are gains on capital. In *J. Darsie Lloyd v. Commissioner*[17] the Board of Tax Appeals applied the principle of *Logan* and held that an annuitant father realized no immediate gain when he transferred appreciated stock to his son, in exchange for the son's promise to pay his father a life annuity. The courts[18] and the commissioner, until very recently,[19] have followed the *Logan* theory of uncertainty of valuation due to potential insolvency of the transferee. In addition, the commissioner and the courts[20] have gone one step beyond the open transaction theory. The annuitant gets a *lifetime* exclusion ratio against all the payments even after the annuitant has recouped his basis. In effect, the transferor gets tax-free gain if he or she survives the life expectancy tables. This is the exact pattern of taxation of regular annuities under IRC § 72. Since a graph is better than words, please refer to tables I and II in the appendix. Table III shows the effect of the open transaction or, in the alternative, section 72-theory using the three and one-half per cent annuity tables of Treas. Reg. § 20.2031-7 (1950), and Table IV shows the same things using the six per cent tables of Treas. Reg. § 20.2031-10. These tables disclose the following points:

(1) The exchange of the property for the unsecured promise to pay is treated as a dual transaction composed of an annuity element and a sale element with the sale being completed only when the basis is recouped.

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16 283 U.S. 404 (1931).

17 33 B.T.A. 903 (1942), *nonacquiesced in,* XV-2 CUM. BULL. 39 (1939), *nonacquiescence withdrawn and acquiescence approved,* 1950-2 CUM. BULL. 3.

18 Commissioner v. Estate of Kann, 174 F.2d 357 (3d Cir. 1949); Evans v. Rothensces, 114 F.2d 958 (3d Cir. 1940); Estate of Hill v. Maloney, 58 F. Supp. 164 (D.N.J. 1944); Bella Hommel, 7 T.C. 992 (1946); Frank C. Deering, 40 B.T.A. 984 (1939).

19 Rev. Rul. 239, 1953-2 CUM. BULL. 53. There the Internal Revenue Service adopted the holding in J. Darsey Lloyd, 33 B.T.A. 903 (1942), and Commissioner v. Estate of Kann, 174 F.2d 357 (3d Cir. 1949).

20 Estate of Hill v. Maloney, 58 F. Supp. 164 (D.N.J. 1944); Rev. Rul. 239, 1953-2 CUM. BULL. 53; Rev Rul. 69-74, 1969-1 CUM. BULL. 43.

(2) The exclusion ratio gives credit for the unrealized appreciation in the transferred property because the investment in the contract equals the fair market value of the property. Thus the annuitant gets a continuing high *lifetime* exclusion. And this high lifetime exclusion bars an increase in the "interest" element reported in each year as ordinary income.

(3) And lastly, carefully note that the interest element is always constant. There is no sudden rise in the annuitant's later years' income when additional income tax may be a great burden.

A technical argument could be made criticizing the Court's open transaction theory in that not every transferee is potentially insolvent. Thus there may be a promise which is capable of valuation. But just because the promise is capable of valuation does not mean that it produces a closed transaction with immediate receipt of cash or its equivalent. It may very well be that an unsecured promise of a wealthy individual cannot be converted readily into cash. Thus there is "no cash or equivalent" to the transferor who has not retained a security interest or obtained promissory notes.[21] Some courts criticize the lack-of-cash-equivalent theory by finding a readily marketable promise in an established market such as in the discounting of future oil production payments.[22] However, a normal private annuity has no ready cash market today. Since it has no ready market, the promise is not cash or its equivalent to the annuitant, and capital gain is not produced until one's basis is recouped.

Nevertheless, it is clear that if the annuitant retained a security interest or took promissory notes, paying out over his life expectancy under the standard tables, the amount realized would be fixed and determinable and he would receive cash or its equivalent back. Clearly there would be a disguised sale with installment payment, resulting in immediate taxation.

How do the courts and the commissioner calculate the elements of exclusion, "interest" and capital gain? Two examples will be used. The first example will involve a cash purchase of an annuity for a man aged seventy-four with $600 payments made at the end of each month. The second example will involve the purchase of an annuity by the same man, but for appreciated property with an adjusted basis of $20,000.00 and fair market value of $43,911.32, the

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[21] Johnson v. Commissioner, 14 T.C. 560 (1950); Ennis v. Commissioner 17 T.C. 465 (1951).

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

same as the cash payment in example one. Assume for purposes of this example that the investment in the contracts equals the fair market value of the property of \$43,911.32. The investment in the contract is the actuarial value of the right to receive the annuity under Treas. Reg. § 20.2031-10 (1970).

EXAMPLE 1: CASH PURCHASE

IRC § 72 describes two elements in every cash annuity contract. The first element is the exclusion ratio, and the second element is the "interest" element. The "interest" element is the difference between the payments received and the excluded portion which is determined by multiplying the exclusion ratio by the payments received. The starting point in any annuity computation is necessarily the exclusion ratio because every computation depends on it.

The exclusion ratio is the ratio of:

$$\frac{\text{INVESTMENT IN THE ANNUITY CONTRACT}^{[23]}}{\text{EXPECTED RETURN}^{[24]}}$$

The expected return equals the yearly return times the life expectancy of the individual under Treas. Reg. § 1.72-9 (1956), Table I.[25] (\$7,200.00 x 10.1 = \$72,720.00). The investment in the contract is the cash paid of \$43,911.32.[26] The exclusion ratio is $\frac{43{,}911.32}{72{,}720.00} =$ 60.4%. Thus 60.4% of the \$7,200.00 received each and every year is non-taxable. This amounts to \$4,348.80. If the annuitant survives 10.1 years, the annuitant will receive his total capital back. (10.1 x \$4,348.80 = \$43,911.32).

The difference between \$7,200.00 per year and the \$4,348.80 exclusion is the "interest" element of \$2,852.20. It is ordinary income deemed to be earned under the imputed interest rate of 6% in the new actuarial tables.

EXAMPLE 2: PURCHASE WITH APPRECIATED PROPERTY

Prior to Rev. Rul. 69-74,[27] the Treasury treated the purchase of

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[23] Treas. Reg. § 1.72-5 (1956).

[24] Treas. Reg. § 1.72-6 (1956).

[25] Rev. Rul. 69-74, 1969-1 CUM. BULL. 43, also uses Table I of Treas. Reg. § 1.72-9 (1956), for determining life expectancy.

[26] For computation of this actuarial value see the computation at Note 2 attached to apps. I-IV at the end of this article.

[27] 1969-1 CUM. BULL. 43.

a private annuity as two transactions:[28] A purchase of an annuity first with a later sale being completed upon successful recoupment of basis by the annuitant. Thus, there are three periods to be considered in determining the character of the payments:

(1) Payments before basis is recovered.

(2) Payments after basis is recovered, but before fair market value is recovered.

(3) Payments after fair market value is recovered.

Consulting Table II of the appendix, one sees that the annuitant's basis of $20,000 is recovered within five years. During the first four years, the exclusion and the annuity ordinary income totals $7,200. But in the fifth year, the basis will be recouped. Now the *Logan* rule applies, and part or all of the exclusion is considered capital gain. The capital gain element and the exclusion allowed now equal the exclusion allowed if cash had been used. There is sound reasoning behind this approach. Because the Treasury gave the taxpayer credit in the exclusion ratio for the untaxed, unrealized appreciation, then after the basis is recouped a part of the exclusion is due to the unrealized appreciation which should be taxed when the transaction is closed. If the government allowed the full exclusion ratio, the unrealized appreciation would never be taxed—only the interest element would be. The transaction is closed under *Logan* after basis is recouped so there should be a reporting of gain beginning in the fifth year. The amount of capital gain reported each year does not exceed the exclusion allowed, because if the capital gain element did exceed the exclusion the interest element would be reduced.

In the years six through eleven the full unrealized appreciation is taxed. Effectively, in the first 10.1 years (annuitant's life expectancy), the taxpayer recoups his basis and the fully taxed capital gain. The years between recoupment of basis and return of initial fair market value of the property is period two in our analysis.

Period three is that period following the return of the investment in the contract equal to the fair market value of the property or $43,911.32. It starts the moment the annuitant has survived his life expectancy of 10.1 years. Thus in the eleventh year, $3,925.48 is excluded so that the capital gain reported and the exclusion equal 60.4% of the yearly payments of $7,200.00. The exclusion is necessary to avoid paying more gain than the "interest" element and the capital gain element. For the lifetime of the annuitant the exclusion

[28] Rev. Rul. 239, 1953-2 CUM. BULL. 53.

ratio remains constant and the interest element remains constant. In other words, the government credits the adjusted basis of the property contributed and the amount of capital gain taxed to the investment in the contract for purposes of computing the lifetime exclusion ratio. This allows tax free recoupment of basis and previously taxed capital gains. The interest element is never part of the exclusion ratio since it is not invested in the contract and thus is entitled to exclusion.

In summary, the favorable income tax characteristics of the transaction for the annuitant are: (1) the crediting of unrealized appreciation to investment in the contract to increase the lifetime exclusion ratio; (2) the reporting of capital gain only after basis is recouped; (3) a constant fixed interest element throughout the life of the agreement.

In example one, cash was paid for the contract, and thus it is the investment in the contract.[29] However, in example two, an assumption was made that the property had a value equivalent to the value of the contract under the actuarial tables in Treas. Reg. § 20.2031-10 (1970) and that this value was the investment in the contract. Implicit in this assumption is the proposition that the investment in the contract is equivalent to the actuarial value of the annuity payments under the commissioner's estate and gift tax tables. While the commissioner[30] and some cases[31] presently take this view, another line of cases looks to the value of a comparable commercial annuity using the tables in Treas. Reg. § 1.72-9 (1956). These cases present three distinct approaches:

(1) investment in the contract equals the value of a comparable commercial annuity;[32]

(2) that assuming there is no donative intent, then the investment in the contract equals the fair market value of the property transferred;[33]

(3) that the investment in the contract is determined using Life Table 38 in the estate and gift tax regulations.[34]

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29 INT. REV. CODE of 1954, § 72(c)(1)(A).

30 Rev. Rul. 69-74, 1969-1 CUM. BULL. 43.

31 Dix v. Commissioner, 392 F.2d 313 (4th Cir. 1968), *aff'g* 46 T.C. 796 (1966).

32 Gillespie v. Commissioner, 43 B.T.A. 399 (1941); Raymond v. Commissioner, 40 B.T.A. 244 (1939).

33 De Canizares v. Commissioner, 32 T.C. 345 (1959); Commissioner v. Moore Corp., 42 F.2d 186 (2d Cir. 1930).

34 Rev. Rul. 69-74, 1969-1 CUM. BULL. 43.

The third alternative is the position presently held by the Treasury, while alternative two was their former position.[35]

By using the estate tax tables, alternatives two and three are the same since, if there is no gift element in the contract, the fair market value of the property equals the value of the annuity under Table 38. On the other hand, by using the commercial annuity tables, alternatives one and two are the same since the value of a commercial annuity will equal the value of the property. The real problem boils down to which set of tables to use.

Example two used the estate tables in Treas. Reg. § 20.2031-10 (1970). These tables are the successor to the three and one half per cent tables in Treas. Reg. § 20.2031-7 (1958). The example adopted the Treasury position of using the estate tax tables rather than the commercial tables.

The reasons for preferring the estate tax tables to the commercial tables in private annuity transactions are basically mathematical. Government actuaries determined that the commercial tables have built in profit and expense margins not necessary in a private transaction. These mathematicians determined that the reserve and investment requirements of the state laws covering annuity issuers are not part of a private annuity transaction. One case, *Dix v. Commissioner*,[36] accepted the testimony of a government actuary and held that the estate tax tables were the better choice. The tables used then were the three and one-half per cent estate tax tables. The commissioner, in Rev. Rul. 69-74,[37] justified the use of these tables by holding that Treas. Reg. § 1.101-2 (e) (iii) (6) (3) (1957) (amended) prescribes such use. The court agreed.

The *Dix* decision came under fire[38] because the use of antiquated three and one-half per cent tables based upon life expectancies of thirty years ago which make no distinction between men and women. The commissioner recognized this problem and solved it by providing more modern estate gift tax tables. These tables provide a higher rate of return, i.e., six percent, use of more modern life expectancies, and distinctions between the sexes. From this point on, it will be assumed that the investment in the contract is figured using the estate tax tables.

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35 Rev. Rul. 239, 1953-2 CUM. BULL. 53.

36 392 F.2d 313 (4th Cir. 1968).

37 1969-1 CUM. BULL. 43.

38 Sams, *Private Annuities: Revnue Ruling 69-74 — Its Significance, Effect, and Validity*, 23 VAND. L. REV. 681 (1970); Johnson, *Latest Developments in the Tax Treatment of Private Annuity Transactions*, 47 TEXAS L. REV. 1409 (1969).

The government has not only attacked the taxpayer's use of commercial annuity tables, but also attacked the favorable income taxation of the annuitant under IRC § 72 using the open transaction theory. In 1954, the commissioner proposed a new Section 1241 which would have taxed the transferor on the gain immediately. The Senate Finance Committee rejected the proposal.[39] The commissioner tried again in 1963 to close the transaction and get the gain reported immediately. Again, the proposal was rejected.[40] Failing legislatively, the commissioner has tried a whittling approach by issuing three rulings:

(1) Rev. Rul. 62-136[41] held that a transfer to an organization issuing private annuity contracts from time to time was a closed transaction requiring valuation using the commercial annuity tables.[42] The ruling primarily covers charitable and and educational institutions. The ruling defines "from time to time" as requiring issuance of enough annuity contracts to obtain a good spread of the actuarial risk. Charitable and educational institutions are the largest issuers of quasi-private annuities.

(2) Rev. Rul. 68-183[43] held that a transferor retained a life-estate in selling appreciated property to a trust he had funded when the total income of the trust was used to satisfy the private annuity obligation. The grantor was taxable on the whole income of the trust under IRC § 677(a) (1) and that income was ordinary.

(3) Rev. Rul. 69-74[44] held that even a private annuity is a closed transaction requiring immediate but ratable reporting of capital gain.

It seems that the Internal Revenue Service is closing the door with this last ruling. The Service has informally indicated that the 1954 Code will not support the open transaction theory.[45] The Service has refused to issue rulings in any private annuity transaction[46] and will attempt to close the transaction if it finds a security interest.[47]

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39 S. 1622, 83d Cong., 2d Sess. § 11 (1954).

40 Ellis, 195 T.M. (B.N.A.) *Private Annuities.*

41 1962-2 Cum. Bull. 12.

42 Rev. Rul. 62-137, 1962-2 Cum. Bull. 28.

43 1968-1 Cum. Bull. 308.

44 1969-1 Cum. Bull. 43.

45 18 ABA Tax Section Bulletin 76 (1965).

46 Rev. Rul. 239, 1953-2 Cum. Bull. 53.

47 Lloyd v. Commissioner, 33 B.T.A. 903 (1935), intimated that the receipt of a security interest would close the transaction.

The rest of this article will be spent discussing the ramifications of Rev. Rul. 69-74 on income, gift and estate tax planning. All future discussions will explore the use of the government's theory of a closed transaction rather than the taxpayer's theory of an open transaction.

III. THE INCOME TAX EFFECT OF REVENUE RULING 69-74

Rev. Rul. 69-74 changed the income tax treatment of the annuitant only. It provided for a closed transaction with an immediate ratable reporting of capital gain over the life expectancy of the transferor as determined under Treas. Reg. § 1.72-9 (1956) Table I. It reduced the exclusion ratio by defining the investment in the contract as the adjusted basis of the transferor in the appreciated property. The investment in the contract remains the same throughout the life of the annuitant even though capital gains are taxed ratably over the life expectancy of the annuitant. If the annuitant outlives his life expectancy, his investment in the contract is still the same original adjusted basis as of the day he entered into the contract. U.S. Life Table 38 is to be used in accordance with instructions in Treas. Reg. § 1.101-2 (e) (1) (iii) (b) (3) (1957). These tables are the estate and gift tax tables found in Treas. Reg. § 20.2031-7 (1957), as amended in 1970 and as modified by Treas. Reg. § 20.2031-10 (1970) (six percent tables).[48]

In summary, the three major differences are: (1) that there is an immediate recognition of gain before basis is recouped; (2) that there is a lower lifetime exclusion ratio due to equating the investment in the contract with the initial adjusted basis of the property; (3) that there is a tremendous rise in ordinary income reportable if and when the annuitant survives his life expectancy.

In 1969 the door seemed to close on the favorable open transaction treatment to the annuitant in a private annuity transaction. What happened to cause the government to overthrow prior court decisions and even its own former position regarding the income taxation of private annuities?[49] Congressional intent in enacting IRC § 72 seemed to call for the following of prior law; it only adjusted the mathematical computations to allow the annuitant to

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[48] For a graphic picture of the results of these changes see Tables in apps. I-IV which show the dollars and cents effect of the change in theory from the open transaction approach under § 72 to the closed transaction approach under Rev. Rul. 69-74 under both the 3½% and 6% tables. See also the attached explanation of the basic factual assumptions and computations, as well as for a detailed explanation of the difference in the approaches.

[49] Rev. Rul. 69-74, 1969-1 CUM. BULL. 43.

recover his cost, tax-free, and attempted to eliminate the shock of sudden increased taxation once the cost had been recouped which had existed under the Internal Revenue Code of 1939.[50] How could the government obtain authority to implement Section 72 when the 1954 Code itself gave the secretary or his delegate no authority to make law? Is this another example of unauthorized legislation like the Kintner Regulations[51] which have been struck down so many times? If the transaction is truly open under the principle of *Burnet v. Logan*,[52] the commissioner cannot close it. There is no income to be taxed until the annuitant recovers his basis. But the Internal Revenue Service contends that the annuitant must pay a tax on capital gains before basis is recouped.

Is there justifiable authority for the commissioner to claim that Section 72 changed the prior law which said that a private annuity was an open transaction, when all Section 72 did was to codify prior case law and change around the mathematical computations?

There seems to be justifiable authority for the commissioner's claim that Section 72 changed the prior law as it existed under IRC § 22(b) (2) (A).[53] The commissioner seems to be correct in claiming that the basis would not be recouped until the annuitant survived to the full measure of his or her life expectancy. The only way the basis could be recouped completely before gain would be recognized would be to allow the difference between the yearly payment and the interest element to be excluded from income until the total basis had been recouped. Thereafter, the exclusion ratio would change radically to zero because the basis had been fully recouped. However, this would violate the requirements of Section 72 which provides for a *constant* exclusion ratio, even if the exclusion ratio reverted to a figure equal to

$$\frac{\text{INVESTMENT IN THE CONTRACT.}}{\text{EXPECTED RETURN}}$$

After the basis had been recouped the exclusion ratio would still not be constant. Thus, if the commissioner is to follow the logic of Section 72 in requiring a constant exclusion ratio, the commissioner must provide for ratable recoupment of basis using a constant exclusion ratio.

[50] For a review of Congressional intent see S. 1622, 83d Song., 2d Sess. § 11 (1954).

[51] Treas. Reg. 301, § 7701.7, T.D. 6503, 1962-2 CUM. BULL. 412.

[52] 283 U.S. 404 (1931).

[53] 68A Stat. 20, (now INT. REV. CODE of 1964, § 72).

If the commissioner were sustained in the application of Section 72, he would also have to be sustained on the ratable report of the capital gain element under the life expectancy of the annuitant. First of all, the commissioner must consider the differences between the total yearly annuity payments and the sum of the exclusion and imputed interest element as a capital gain only. If the capital gain element were also to be excluded we would have an inconsistency because the exclusion ratio would not be constant. Once the difference between the total yearly payment and the sum of the yearly exclusion and the yearly "interest" element is called capital gain, the commissioner must necessarily recoup the capital gain under the life expectancy of the annuitant. Therefore, once Section 72 is selected as the mathematical model for the treatment of private annuities the commissioner's interpretation as presented in Rev. Rul. 69-74 has to follow.

This can be seen by the following mathematical proof.

1. Notation: Let T=Life expectancy of the annuitant

Let P=Total yearly payments

Let E=Expected return=(T) (P)

Let AB=Adjusted basis of the transferred property

Let X_c=Yearly exclusion (constant)=

$$P \left(\frac{\text{Investment in the Contract}}{\text{Expected Return}}\right) =$$

$$(P) \left(\frac{AB}{E}\right) = (P) \frac{(AB)}{(T)\ (P)} = \frac{AB}{T}$$

Let I=Total interest over life expectancy at 6% compound interest per year.

Let $\frac{I}{T}$ =Yearly interest

Let CG=Total capital gain in property

Let CG_n=Capital gain reported in year (n)

Let CG_z=Capital gain reported in the calendar year immediately before the calendar year in which the life expectancy (T) is reached.

2. The yearly amounts of capital gain are as follows:

$$CG_1 = P - X_c - \left(\frac{I}{T}\right)$$

$$CG_2 = P - X_c - \left(\frac{I}{T}\right)$$

$$\vdots \qquad \vdots$$

$$CG_n = P - X_c - \left(\frac{I}{T}\right)$$

$$\vdots \qquad \vdots$$

$$CG_z = P - X_c - \left(\frac{I}{T}\right)$$

$$CG_t = \left[P - X_c - \left(\frac{I}{T}\right)\right] [T - (z)]$$

3. $\therefore \sum_{n=1}^{T} \text{(sum) } CG_n = \left[P - X_c - \left(\frac{I}{T}\right)\right] [T - (z) + (z)]$

$$= T \left[P - X_c - \left(\frac{I}{T}\right)\right.$$

$$= [(T)\ (P)] - [(T)\ (X_c)] - I$$

4. $[(T)\ (X_c)] = T \left(\frac{AB}{T}\right) = AB$

5. $[(T)\ (P)]$ =Total payments made during the life expectancy of the annuitant

=Return of fair market value of the property transferred plus "interest"

=FMV prop. + 1

6. $\therefore \sum_{n=1}^{T} CG_n = [(T)\ (P)] - [(T)\ X_c)] - I =$

FMV Prop. + I-AB-I=FMV-AB=CG [54]

IV. FURTHER INCOME TAX CONSEQUENCES OF A PRIVATE ANNUITY

Regardless of whether Section 72 or Rev. Rul. 69-74 is used, there are some income tax consequences to the transferee and the trans-

[54] Conclusion: From this proof it becomes obvious that once Section 72 is selected as the mathematical model for the treatment of private annuities, the commissioner's interpretation as presented in Rev. Rul. 69-74 has to follow.

feror that remain unchanged. First to be considered will be the consequences to the transferor.

A. THE TRANSFEROR

1. *RECAPTURE*

Recapture under IRC §§ 1245 and 1250 presents two problems: (1) how much is recaptured and (2) when does the recapture occur. If one does not know the amount realized, one cannot decide which is the lower—the recomputer basis or the amount realized. Either we are forced to use the recomputer basis as the amount subject to recapture, or we must find some way to actuarily determine the amount realized. Because there are no cases, rulings or regulations, the only guess that can be made is that the amount realized equals the actuarial value of the promise. As with the capital gain under Rev. Rul. 69-74, one may end up reporting ordinary income recapture when one really has none, because basis has not been recouped.

Further, should the taxpayer report the ordinary income recaptured pro-rata over his life expectancy or should it be recaptured immediately from the excluded portion? One commentator[55] has suggested that neither the interest element nor the excluded portion should be taxed as recapture income until the adjusted basis of the property is recouped, and then recapture would set in. Under Section 72 treatment, prior to Rev. Rul 69-74, this is what would happen. Then, after full recapture, capital gain would be recognized.

Under Rev. Rul. 69-74, either the recapture income is reported ratably over the annuitant's life expectancy or the recapture income is reported immediately. If the recapture income were reported immediately what would normally be capital gain would be ordinary income. Ratable reporting of the recapture income seems fairer to the taxpayer because, should the taxpayer die early, the amount of ordinary income recaptured before recoupment of basis is reduced to a minimum. Ratable reporting of recapture income follows the installment method election under IRC § 453. It is harsh enough treatment for the taxpayer to require reporting of capital gain before basis is recouped, let alone requiring reporting of recapture income before basis is recouped.

2. *LOSSES OF THE TRANSFEROR*

Losses incurred in entering into a private annuity (as where the basis is greater than the amount realized) present the same problem

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[55] Ellis, 195 T.M. (B.N.A.) *Private Annuities.*

as reporting gains, namely, is the recognized loss involved in an open transaction or a closed transaction?

If the transaction is indeed open, losses would not be recognized until the amount realized was finally determined at the annuitant's death. If the transaction is closed, losses would be determined relying on the actuarial value of the future payments as equalling the amount realized. Later adjustments would be made if the amount realized was greater or lesser than the actuarial computation.

Of course, the previous discussion may be moot if the losses are not recognized. Some cases hold that since the transaction is not entered into for profit there can be no loss.[56] Other cases say the transaction was entered into for profit because the transferee entered the transaction with a profit motive.[57] Even if the transferor should get by this hurdle, IRC § 267 bars recognition of losses between related individuals. The best answer is to avoid the problem by selling the property, thus recognizing a loss first and then using the cash to fund the private annuity.

A loss can be realized if the transferor paid for the annuity for life and died early. But cases deny this loss to the annuitant's estate, because the annuitant received what he bargained for.[58] The arguments mentioned above, namely that the transaction was not entered into for profit and that Section 267 bars losses between related individuals, also apply.

3. *STOCK REDEMPTIONS*

If the father and son own stock in a close corporation, the son could exchange a private annuity for his father's stock. But the son would be paying for the stock with after-tax dollars. Whereas, if the corporation redeemed the stock for a private annuity, the remaining shareholders would receive the same benefit without a double tax. To avoid the family attribution rules of IRC § 318, one must make sure to have the father withdraw as a corporate officer[59] and also hold instruments of indebtedness as a creditor only. If the transferor's life expectancy is fifteen years or more, is he a mere creditor or a shareholder?[60] In any case the area is uncertain, and

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[56] *See, e.g.*, Evans v. Rothensces, 114 F.2d 958 (3d Cir. 1940).

[57] *See, e.g.*, Sheridan v. Commissioner, 18 T.C. 381 (1952).

[58] Industrial Trust Co. v. Broderick, 94 F.2d 927 (1st Cir. 1938); Helvering v. Louis, 77 F.2d 386 (D.C. Cir. 1935), *rev'g* 29 B.T.A. 1200 (1934).

[59] INT. REV. CODE of 1954, § 302(b)3.

[60] INT. REV. CODE of 1954, § 318(s).

care must be taken to avoid the problem by using short term notes of such duration as to provide adequate income to the annuitant without impairing the working capital of the corporation. The consequences to the transferee will now be examined.

B. The Transferee

1. *BASIS FOR DEPRECIATION OF PROPERTY RECEIVED*

The transferee has a variable basis for depreciation which changes each time a payment is made. The basis under Rev. Rul. 55-119[61] *before death* is the value of the promise of a future annuity until the payments equal the value of the promise computed as of the day of the transfer of the property. If the payments exceed the initial value of the annuity promise, the payments are added to the basis each year until the transferor dies. The effect of the ruling approach is to allow larger and larger depreciation deductions if the transferor survives his life expectancy, or if the useful life of the property is exhausted before the transferor dies. *After death* the basis may change radically in that it is the totality of all payments actually made less all depreciation.

2. *SALE OF PROPERTY TRANSFERRED*[62]

a. BEFORE DEATH OF ANNUITANT

1. ADJUSTED BASIS FOR GAIN. The unadjusted basis for the transferred property is the sum of the payments made plus the actuarial value of all future payments. Depreciation adjustments must be made to calculate the adjusted basis.

2. ADJUSTED BASIS FOR LOSS. The unadjusted basis for loss is the totality of payments made. This is necessary because if the actuarial value of the future payments were part of the loss basis, then a loss could be taken before any was produced. In fact, it is possible (if one computed the loss basis using the actuarial value of future payments) to have a loss and yet have the taxpayer realize a windfall by the annuitant's early death. The commissioner will only allow such a loss as is certain at the moment of computation. In addition, normal depreciation adjustments are necessary here too so that the adjusted basis can be computed.

3. NEITHER GAIN NOR LOSS POSSIBLE. If adjusted basis for loss is less than or equal to the price paid for the property, and

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[61] 1955-1 Cum. Bull. 352.

[62] Rev. Rul. 55-119, 1955-1 Cum. Bull. 352.

the price paid is less than or equal to the adjusted basis for gain, neither gain nor loss would be realized.

b. AFTER DEATH OF ANNUITANT. If the transferee sells the property after the death of the transferor, the adjusted basis is the totality of payments made less any depreciation deductions taken.

3. *PAYMENTS MADE AFTER SALE OF PROPERTY*[63]

a. GAIN ON SALE.

If the final basis of the property to the transferee is less than the actuarial value of the future annuity payments at the time of the sale, plus the actual payments made, less depreciation adjustments, additional gain is recognized on the death of the annuitant. Conversely, if the transferor dies after the actual value of the future payments is reached, loss is recognized. In both cases, the test is whether the payments after the sale are less than or greater than the actuarially calculated value used in the gain computation. If the payments made after the sale exactly equal the computed actuarial value, there is neither gain nor loss.

b. LOSS ON SALE.

If an initial loss was recognized on the sale, a later payment accentuates that loss. The loss is deductible in the year in which the payment is made. The rules for payments made after the sale of property observe the annual accounting concept.

c. NEITHER GAIN NOR LOSS WAS RECOGNIZED.[64]

New computations need to be made because we are not merely adjusting prior reported gain or loss. Payments made during the transferor's life only create loss when the totality of payments, less accumulated depreciation, exceed the amount realized on the sale. After the transferor's death, if the totality of payments made less depreciation is less than the amount realized, gain is recognized.

d. CHARACTER OF GAIN OR LOSS.

Rev. Rul. 55-119[65] characterizes loss or gain recognized by looking to the nature of the prior transaction. The ruling follows *Arrow-*

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[63] *Id.*

[64] Rev. Rul. 55-119, 1955-1 CUM. BULL. 352.

[65] 1955-1 CUM. BULL. 352.

smith v. Commissioner.[66] Thus any subsequent payments, whether resulting in gain or loss, will be capital, if a capital asset or a Section 1231 asset[67] is involved.

e. INTEREST DEDUCTIONS FOR ANNUITY PAYMENTS.

Surprisingly, even though the annuity tables are based on a six percent "interest" element, which is treated as ordinary income each year by the annuitant, the transferee gets no interest deduction. Many cases do not refer to the annuity payment consideration paid as "interest."[68] IRC § 483(e)5 provides that when no interest is stated in an annuity contract, there is no interest element. No decided case has determined whether the interest deduction is allowable when there is a specific amount of interest stated in the contract.

V. ESTATE AND GIFT TAX CONSEQUENCES OF A PRIVATE ANNUITY

There are also estate and gift tax consequences which will not vary regardless of whether you use the open transaction theory or the closed transaction theory.

A. Gift Tax Consequences

It is entirely possible that the commissioner could determine the fair market value to be greater than the value used by the parties in the private annuity transaction. If the value finally determined exceeded the taxpayer's valuation, then a gift was made. Further, if the commissioner finds that the annuitant was in the advance stages of cancer and had a life expectancy of one month, even though the tables provided a ten year life expectancy, there is no reason why the commissioner could not find a gift. While there are no cases on the commissioner's side, taxpayers have been successful in breaching the tables.[69]

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66 344 U.S. 6 (1952).

67 Int. Rev. Code of 1954, § 1231. This section provides for capital gains where the asset is used in a trade or business, or where there has been an involuntary conversion of a capital asset held for more than 6 months.

68 Kaufman's Inc. v. Commissioner, 28 T.C. 1179 (1957). One case, Reliable Incubator and Border Co. v. Commissioner, 6 T.C. 919 (1946), held that the private annuity involved no interest because the obligation is not a debt.

69 Estate of Butler v. Commissioner, 18 T.C. 914 (1952). *See also* Rev. Rul. 66-307, 1966-2 Cum. Bull. 429.

If a gift is found, then the $30,000.00 lifetime exemption and the $3,000.00 yearly exclusion apply.[70] The real problem is determining the proper method of finding a basis in a partial gift and partial "sale."

Rev. Rul. 55-119[71] presents a solution using the regulations under the Internal Revenue Code of 1939 when there was no specific regulation section in point as there is today under Treas. Reg. 1.1015-4 (1957). The solution under the ruling is to provide two bases, one for the gift and one for the annuity, and then to define the basis for the property as being the sum. Thus the transferee's basis for gain, loss and depreciation on the gift portion is the donor's basis minus the value of the prospective annuity payments, and the basis for the annuity is the present value of the payments. The total is the new basis.

Perhaps a simple example will suffice to show how Rev. Rul. 55-119 applies. Assume the property has a fair market value of $200,000.00 and an adjusted basis of $150,000.00 and that the value of the annuity payments is $103,710.50. The adjusted basis of the gift portion of the property is $150,000.00 less $103,710.50 or $46,289.50. While the adjusted basis of the portion of the property which purchased the annuity is $103,710.50, the total basis of the property is $150,000.00.

Adjusted basis under Treas. Reg. § 1.1015-4 (1957) is the greater of the transferor's adjusted basis or the amount paid (present value of the annuity) plus the gift tax paid; limited, however, for losses to the fair market value of the property at the time of the transfer. If one considers that the gift part of the property is never to have a negative basis, the basis for the annuity to the transferee under Rev. Rul. 55-119 and Treas. Reg. 1.105-4 will be the same, according to the mathematical proof in the footnotes.[72] Thus it really makes no difference which method you use, except that Treas. Reg. 1.1015-4 takes into account the gift tax adjustments allowed to the basis given under the Technical Amendments Act of 1958,[73] while one must write in that adjustment under Rev. Rul. 55-119.

If there is a deliberate or hidden gift element, and the transferor survives three years, the gift element is not included in the estate of the transferor. There is no transfer in contemplation of death,[74]

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70 *See* INT. REV. CODE of 1954, § 2503.

71 1955-1 CUM. BULL. 352.

72 *See* app. V.

73 *See* Treas. Reg. § 1.1015-5(a)(1)(i); INT. REV. CODE of 1954, § 1015 (d).

74 INT. REV. CODE of 1954, § 2035.

or a retained life estate,[75] since the transferor did not contract to receive the income for life but received a guaranteed payment. Thus the property is out of the estate in the simple private annuity situation at a minor gift tax cost.

If the property is included under IRC § 2035, the whole value is placed in the estate, including the appreciation, and a deduction under IRC § 2043 is allowed for the present value of the annuity at the time of the transfer. Thus the property is partially included in the estate—appreciation and gift element together—in return for an adjusted basis equal to fair market value at death under IRC § 1014[76] and a gift tax credit.[77] There is one exception to the fair market value basis rules and that is where the property is sold before death. There is a question as to whether the donee gets a new basis at death and for what and for how much. Section 1014 (a) bars a new basis if the property is sold before death, however, the regulations[78] provide one exception where the property is trusteed. The fair market value of the property purchased with the gift would be the new basis for the trusteed property.

B. Estate Tax Consequences

In addition to the contemplation of death question previously discussed, there are problems under IRC §§ 2036 and 2037. Let us assume for purposes of discussion that there is no gift element involved. Thus the transaction was for full and fair consideration under IRC § 2043. Under Sections 2036 and 2037 there seemingly should be no problem because the transfers are for full and adequate consideration. However, there would be a claim for a disguised life estate or a claim of a transfer taking effect at death under Section 2037 if the annuitant retained a security interest.

Even though the legal rights and consequences of a private annuity and a life estate are different, the economic characteristics are so close that it is possible to classify the one transaction as being the other. Let us see how close they can really be made. If the annuity payments equal the annual income there seems to be no economic distinction. Suppose further that the payments were limited to income from the property, or that the agreement imposes liability upon only the property and not the transferee. Suppose the transferor had a veto power over sale or other key

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75 Int. Rev. Code of 1954, § 2036.

76 Int. Rev. Code of 1954, § 1014(b)9.

77 Int. Rev. Code of 1954, § 2012.

78 Treas. Reg. § 1.1014-3(d).

administrative powers. The two property interests seem indistinguishable.

The Internal Revenue Service has recognized that, based upon economic consequences alone, it is virtually impossible to distinguish between income coming from a life estate and income coming from a private annuity. In Rev. Rul. 68-183[79] the Service held that where a transferor funded a trust for another with X stock and then sold Y stock to the trust in return for a private annuity, the grantor was the owner of the property for income tax purposes under IRC § 677 (a) (1), because the total income of the property was used to pay the private annuity. Although no mention was made of the estate tax implications, one wonders whether the finding of a life estate on the income tax side necessarily applies to a retained life estate on the estate tax side.

The rationale of the ruling does not cover the basic definitional distinctions between a private annuity and a life estate. The ruling's test is the economic-reality test of whether or not the income could only come from the property or could in addition come from the transferee. I would like to propose a definitional distinction as a hypothetical resolution to problems in the area. The principal difference between a life estate and a private annuity is analogous to the difference between taking property subject to a mortgage and having the transferee assume the mortgage. If only the property is liable for payment, then we have a life estate; if, in addition, the transferee is liable for payment personally, then we have a private annuity. The Internal Revenue Service feels that if a grantor transfers property and then negotiates a private annuity for other property so that he effectively received all the income from the trust, there is a life estate because the only real source of payment is the income from the property in trust.

Economically this may be true, but not legally. If the trustee is personally liable for payment, he can borrow the money, obtain contributions from the donee or sell the property itself. Whereas, if only the property is liable, the only thing the transferor is entitled to is the income. The commissioner seems to be incorrect in being unable to distinguish economic results from the basic legal nature of the transaction.

The test for whether the transferor has a life estate for estate tax purposes is whether he can legally control the income of the property. If, in the case used in Rev. Rul. 68-163,[80] the income of

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[79] 1968 INT. REV. BULL. No. 16, at 19.

[80] *Id.*.

the property went to zero, the transferee trustee would be liable and could be contractually forced to pay. Thus there is no retained life estate for estate tax purposes. Further, even if the commissioner claimed there was, as long as there was full and fair consideration, IRC § 2036 could not apply.

Rev. Rul. 68-183 may even be incorrect in finding a life estate under the Clifford Rules[81] of IRC §§ 671 to 678. Section 677 (a) (1)[82] does not incorporate the fair and adequate consideration rules of Section 2036. One can only wonder whether under Section 677 the transferor must retain the power or be the beneficiary of the power from the beginning of the trust, or whether he could be deemed to acquire the power in an arm's length transaction later on.

Retention of a security interest allowing repossession upon default may be equivalent to a transfer taking effect in possession or enjoyment at death, to which Section 2037 would apply.[83] One case held that mere retention of the interest alone was not enough.[84] It is doubtful, in view of the fair and adequate consideration given for the annuity, whether IRC §§ 2035 through 2038 would ever operate. However, the retention of the security interest may close the transaction.[85]

SUMMARY: Where there is no gift, you are saving estate tax at the cost of a potentially lower basis which would reduce depreciation and adjust gain upward. Where there is a gift element, and the gift is not included because it is without the three year period provided in Section 2035, you are saving estate tax at the cost of a lower basis and a gift tax. Where part of the property is included in the estate as a gift, then, as to the included item, there is a basis adjustment upward at an estate tax cost. There is a credit for the gift tax paid on the included portion.[86] As to the excluded portion, estate tax is saved at the cost of a lower income tax basis. In some cases, inclusion of less than sixty thousand dollars of gifts will produce a new basis without any estate tax cost due to the exemption.[87] These results occur regardless of whether the open transac-

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81 Helvering v. Clifford, 309 U.S. 331 (1940).

82 INT. REV. CODE of 1954, § 677(a) (1).

83 Tips v. Bass, 21 F.2d 460 (W.D. Tex. 1927). This case held that the retention of a security interest did not cause inclusion in the estate.

84 Johnson v. Commissioner, 10 B.T.A. 411 (1928).

85 Lloyd v. Commissioner, 33 B.T.A. 903 (1936), implied that the retention of a security interest closed the transaction.

86 INT. REV. CODE of 1954, § 2012.

87 INT. REV. CODE of 1954, § 1014 does not require the payment of estate tax before basis is recouped.

tion theory or the closed transaction theory is applied on the income tax side.

VI. A COMPARISON OF THE APPROACH OF PRIOR LAW AND THAT OF REVENUE RULING 69-74[88]

Under Rev. Rul. 69-74 the estate and gift tax consequences are exactly the same. Likewise, with the exception of the difference as to whether there is an open transaction or a closed transaction, there are no differences on the income tax side.

The major differences in income tax, produced by the differences between open transactions and closed transactions, are as follows:

(1) The annuitant realizes capital gain immediately but it is reported ratably over his life expectancy;

(2) For purposes of computing investment in the contract, the adjusted basis of the property is used rather than its fair market value. Thus the exclusion ratio is lower throughout the life of the annuitant;

(3) If the annuitant outlives his life expectancy, the investment in the contract continues to be the original basis in the property despite the payment of capital gains tax;

(4) U.S. Life Table 38 in Treas. Reg. § 20.2031-10 (1970) is used in determining the present value of the annuity;

(5) And, lastly, Rev. Rul. 239[89] issued under the Int. Rev. Code of 1939 is not applicable to the 1954 Code.

VII. THE ADVANTAGES AND DISADVANTAGES OF THE PRIVATE ANNUITY—BOTH ECONOMIC AND TAX

We have covered but one facet of the problem—the tax consequences. What are some of the advantages and disadvantages from the economic and practical standpoint?

1. If the transferred property is not included in the estate, there is no big cash drain at one time to pay estate taxes. The only residue left would be cash left over from the annuity payments, and lifetime gifts could dissipate this excess if and when the annuitant decided he did not need the money. In any case, the annuitant's nest egg

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[88] 1969-1 Cum. Bull. 43.

[89] 1953-2 Cum. Bull. 53.

can consist of $60,000.00 since the estate tax exemption would allow him that much without tax.[90] If he were married, and the funds were in a joint bank account, because of the effect of the marital deduction it would permit him to retain $120,000.00 tax free.[91]

2. There can be no harmful time and cash consuming litigation over contemplation of death or retained life estate questions, i.e., a) if there were no gift IRC §§ 2035 through 2038 could never apply because adequate consideration was provided, and b) if there were a gift, and there was an ultimate decision that it was in contemplation of death or there was a retained life estate, IRC § 2043 would credit against the inclusion of the fair market value of the property transferred for the annuity at the time of the original transaction. Because of the "Section 2043 credit," a smaller amount would be included in the estate, and this amount would be taxed in a lower bracket.

3. The gift taxes paid would be minimized by the use of the lifetime exemption, the yearly exclusion and the lower gift tax rates equal to about three-quarters of the estate tax rates.[92]

4. A private annuity is available in situations where a commercial annuity is not, for example, where the asset is close corporation stock.

5. Early death of the transferor produces a low basis for depreciation, gain or loss. But if the asset is non-depreciable, and there is little desire to sell, the low basis would make little difference. Further, it may be possible to provide for a high basis on early death.

The two methods which can be used to provide a higher basis on early death are: (1) having the estate of the annuitant guaranteed a certain minimal payment over the years by virtue of the private annuity agreement; and (2) having the widow borrow, using the property as security, so that she can have a minimal "nest egg" before transferring the property and then having the trustee assume the mortgage by getting an agreement from the bank to take the widow's name off as obligor. If route one is taken, the trust could promise the estate "*x*" number of payments after death so that the present value at the time of the transfer of those payments after death so that the present value at the time of the transfer of those payments is $60,000.00. There would be no estate

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[90] INT. REV. CODE of 1954, § 2052.

[91] INT. REV. CODE of 1954, § 2056.

[92] INT. REV. CODE of 1954, §§ 2502 and 2001.

tax.[93] However, there would be income tax on the income in respect of a decedent's estate under IRC § 691 because Treas. Reg. § 1.1014-1 (c) (1) (1957) bars giving any basis to stop recognition of later income. I personally prefer the second plan since the widow has some money of her own initially to do with as she pleases. She is more likely to make the transfer with a certain amount of protection in the bank. The trust gets a basis because of the assumption of the mortgage.[94] The widow retains no security interest because she still has only the personal obligation of the trustee. The property will not be included under IRC § 2037 and the transaction will not be closed.

6. The late death of the transferor will cause the transferee to pay more than the property is worth. However, since a private annuity is inter-family, when one looks at the net economic effect, the heirs receive the same net amount as if the transferor consumed part of the property and they got the residue. Moreover, the payments beyond life expectancy build the basis of the property to compensate for the loss of the ICR § 1014 basis at death which would be available if the property were included in the annuitant's estate.

Care should be taken to assure that the transferee gets income producing property to carry the burden. Generally, the greater the income produced by the property, the greater the reduction in the transferor's income taxes because all he is taxed on is the "six percent interest element on the annuity." This is especially attractive to high bracket taxpayers.

7. The transferee gets no interest deduction because the annuity obligation is not an "indebtedness"[95] or because the "interest" is really consideration paid.[96] Further, IRC § 483(e)(5) provides that even if no interest is specifically stated in the annuity contract, the contract could provide for interest because the cases barring an interest deduction do not cover the situation where the contract has a stated interest element. And, if the money were borrowed to fund the annuity, then the interest on the loan would be deductible either as a businss transaction, one entered into for profit, or one which is totally personal.[97] Borrowing on the property has the

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[93] INT. REV. CODE of 1954, § 2052 exempts $60,000 from taxation.

[94] Crane v. Commissioners, 331 U.S. 1 (1946).

[95] Reliable Incubator and Brooder Co. v. Commissioner, 6 T.C. 919 (1946).

[96] Kaufman's Inc. v. Commissioner, 28 T.C. 1179 (1957).

[97] INT. REV. CODE of 1954, § 163. The only difference in the treatment given the deduction would be whether it is an adjustment to adjusted gross income or an itemized deduction from adjusted gross income.

added advantage that the bank may desire not to see the property dissipated and would act to protect its investment by preventing dissipation of the property.

8. If the transferor retains no security interest to avoid inclusion in his estate and the closing of the transaction, there is no real guarantee of payment except the personal, unsecured promise of an individual. Of course, if the transfer is to a wealthy individual or one who is responsible (a fiduciary) there is less risk of default.

9. If the property is sold early by the transferee, then there is a possibility that the income will be recognized years later when the transferor dies, since the future payments do not equal the actuarial value of the annuity credited against the amount realized at the time of the sale. This is true because the economic gain is the difference between the amount realized and the totality of payments actually made, rather than the higher figure equivalent to the actuarial value of the future payments previously credited against the amount realized to find the gain.

For example, if the property were sold in 1970 for $200,000.00 the gain would be computed as follows:

Amount realized		$200,000.00
Payments made	$ 50,000.00	
Actuarial value of future payments	100,00.00	
		<$150,000.00>
Total gain realized		$ 50,000.00

However, if the transferor dies early when only $50,000.00 of the future payments has been made, the gain realized is $200,000.00 less $100,000.00 or $100,000.00 rather than the $50,000.00 already reported. An extra $50,000.00 of income would be taxable at the death of the annuitant.

The same result would come about if the depreciation taken exceeded the depreciation base at death (the total payments made). The transferee used the actuarial value of the future payments as his adjusted basis, when, in fact, at the death of the transferor, he was only entitled to an adjusted basis equal to the payments made. This excess depreciation is, so to speak, recaptured at death as ordinary income.[98]

For example, if the actuarial value of the future payments at the time of transfer was $150,000.00, the depreciable base would be $150,000.00. If the actual payments totalled only $100,000.00, the

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[98] Rev. Rul. SS-119, 1950-1 CUM. BULL. 352.

transferee would get extra depreciation of $50,000.00 because the final basis would only be $100,000.00 and not the $150,000.00 already depreciated. This extra $50,000.00 of depreciation is recaptured. The answer to this disadvantage is to transfer non-depreciable property which the family desires to keep.

10. There is no loss on the annuitant's final return, because he received exactly what he bargained for.[99] Even if a loss is realized, it has been held that the loss will not be recognized because it was not entered into for profit.[100] A third ground for denying the loss is IRC § 267. If the transferor's losses will not be recognized in the initial transaction because of Section 267, then it is better to sell the property first and preserve the loss for the transferee.

There is a question as to how the transferee would take the loss of the annuity property. Although Rev. Rul. 69-74[101] did not cover the reporting of losses, the same reasoning which required ratably reporting of gain would require ratable reporting of loss.[102]

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[99] Helvering v. Louis, 77 F.2d 386 (D.C. Cir. 1935).

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

[101] 1969-1 CUM. BULL. 43.

[102] Proposition: The realized loss must be reported ratably over the life expectancy of the individual annuitant.

Let AB = Adjusted basis of the property

Let AR = Amount realized = fair market value of property

Let T = Life expectancy

Let L_s = Total realized loss

Let L_n = Yearly loss

Let P_n = Yearly payment.

1. Either the loss is taken immediately or it is taken at some time or times. If the loss were taken immediately, there is a possibility that the annuitant would suffer no economic loss since he may outlive his life expectancy. To allow a realized loss when one did not exist or potentially would not exist seems contrary to the principal that recognized losses must relate to true economic losses.

2. If there were no yearly loss taken, then the total exclusion over the life expectancy of the annuitant would exceed the fair market value of the property or the amount realized:

$$\text{Yearly exclusion} = \left(\frac{AB}{E}\right) \times (P_n) = \left(\frac{AB}{AR+I}\right) \times \left(\frac{AR+I}{T}\right) = \frac{AR+L_s}{T} = \frac{AR}{T} + \frac{L_s}{T}$$

$$\text{Total exclusion over life expectancy } T = (T)\left(\frac{AR}{T} + \frac{L_s}{T}\right) = AR + L_s > AR$$

Since the exclusion cannot exceed the amount realized, there must be some yearly loss realized.

The taxpayer would suffer the same risk with capital losses that he suffers on capital gains realized in a private annuity transaction. It is possible to never realize a loss suffered in exchanging the property for the private annuity, if the annuitant does not live out his life expectancy. If the commissioner is sustained when the taxpayer is required to report capital gain before the recoupment of basis, the commissioner should also be sustained when the taxpayer can not get the full benefits of his loss. The commissioner may be telling the taxpayer, you are not only betting on your life expectancy with the transferee but also with the government.

11. Cash flow is important to the transferee who is saddled with the burden of paying out the fair market value of the property over the life expectancy of the annuitant. He must have enough liquidity to provide the funds required by the annuity agreement.

12. Although the payments made by the transferee are usually made out of after-tax dollars when high basis depreciable property is used, the depreciation reduces the burden and, in effect, makes pre-tax dollars available to pay the obligation. If non-depreciable property is used, the interest on the mortgage would provide the same result. By paying the obligation with pre-tax dollars of the transferee, a double tax is avoided on the property's income—once when it is earned by transferee, and again when the money is received by the transferor.

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3. If there must be a loss taken in some year the loss for that year L_n must either be greater than, less than or equal to the total realized loss spread over the annuitant's life expectancy.

$$\left(\frac{L_s}{T}\right)$$

4. But if the $L_n > \frac{L_s}{T}$, then on the average for the group of individuals in the annuitant's life expectancy group the total loss would be $(T)\ (L_n) > L_s$ or an amount greater than the realized loss L_s.

$\therefore$ It is not possible that $L_n > \frac{L_s}{T}$

5. And if $L_n < \frac{L_s}{T}$, then on the average for the group of individuals in the annuitant's life expectancy group the total loss would be $(T)\ (L_n) < L_s$ or an amount less than the realized loss L_s.

$\therefore$ It is not possible that $L_n < \frac{L_s}{T}$

6. The only alternative left is $L_n = \frac{L_s}{T}$. Therefore, the loss must be reported yearly and the amount must equal the total loss spread over the life expectancy of the annuitant.

13. The commissioner's claim of a hidden gift could cause some of the property to be included in the estate or in the alternative, it could cause a great deal of gift tax. But fair valuation by adequate appraisers has often withstood a redetermination in a proceeding with the Internal Revenue Service.

Before a private annuity becomes feasible, there must be an advantage gained taxwise—i.e., the savings in estate taxes must override the potential income and gift tax costs. Further, there must be economic viability to the transaction to provide the desired results for the family, in passing the property to them with as little a tax burden as possible, and for the transferor who desires and needs security. If the private annuity transaction is to succeed, the annuitant and the family should have everything to gain and nothing to lose. The advantages of the plan should be maximized and the disadvantages overridden or minimized.

The next portion of this paper will be devoted to developing and testing such a plan. A hypothetical will be discussed with all the advantages and very few, if any, of the disadvantages found in private annuity transactions. Next, the possibility of additional variations will be discussed. And lastly, the thrust and potential affect of future legislation will be covered.

VIII. HYPOTHETICAL—THE WIDOW'S PRIVATE ANNUITY

Assume husband (*H*) dies leaving wife (*W*) surviving but provides for her under the classic two trust system as follows:

(1) Wife (*W*) receives a fractional share of the estate assets so as to qualify for the maximum marital deduction.[103] The widow has a life estate coupled with a general power of appointment at death and a special power of appointment during life to take any part or the whole of the property in the marital deduction trust and purchase a private annuity from the non-marital family trust. However, she is not required to purchase such an annuity.

(2) *W* receives a life estate in all the trust income as defined in the instrument but does not receive any other powers. In case of default of appointment under the marital deduction trust, *W's* property goes to the residuary beneficiaries of the family or non-marital deduction trust. The wife may or may not have a limited power of appointment to a set class of residuary heirs.

If the wife elects to take the private annuity in return for her marital share, she is to receive no income under the trust and is

[103] INT. REV. CODE of 1954, § 2056.

not to be considered a beneficiary thereof. Further, the trustee is specifically authorized to borrow on the whole trust to obtain cash to pay any annuity obligations if the widow so elects to trade her marital trust share for a private annuity. In the alternative, the trustee can assume the widow's mortgages.

(3) Assume *W* receives non-depreciable property in the marital deduction trust (say, for example, close corporation stock). Assume the estate tax return was audited and a settlement was reached establishing the fair market value of the property. Thus the adjusted basis under IRC § 1014 is presumptively the estate tax value of the property.[104]

A. BASIC TAX CONSEQUENCES WHEN WIDOW ELECTS ANNUITY

1. *INCOME TAX*

Since adjusted basis equals fair market value, there is neither gain nor loss in the exchange of the marital trust property for the annuity. There can be no immediate recognition of capital gain because there is none—regardless of whether you apply the open transaction theory or the closed transaction theory. The investment in the contract under Rev. Rul. 69-74[105] is the adjusted basis of the property which here is the same as the fair market value of the property. Further, because the investment in the contract is the same under IRC § 72 as it is under Rev. Rul. 69-74, the exclusion ratio is the same. Under both rules the widow would receive the same lifetime exclusion. The result of the plan is to bar a sudden rise in the ordinary income element after the annuitant has survived her life expectancy. In short, when adjusted basis equals the fair market value, the harsh results of Rev. Rul. 69-74 are gone and the taxpayer really gets the benefit of the Section 72 rules.

If the fair market value of the property exchanged for the annuity is \$100,000.00, then the adjusted basis of the exchanged property is also \$100,000.00 under IRC § 1014. There can be no capital gain on the transfer of the property for the annuity because the adjusted basis equals the amount realized or the fair market value of the annuity. The exclusion ratio under Rev. Rul. 69-74 and Section 72 is the same:

$$\frac{\$100{,}000.00\text{—Investment in the Contract}}{\text{Expected return}} = \text{Exclusion ratio}$$

This lifetime exclusion ratio is higher than it would be under Rev.

[104] Rev. Rul. 54-97, 1954-1 CUM. BULL. 113.

[105] 1969-1 CUM. BULL. 43.

Rul. 69-74 if the adjusted basis in the property before death was $10,000 since

$$\left(\frac{\$10{,}000.00}{\text{Expected return}}\right) < \left(\frac{\$100{,}000.00}{\text{Expected return}}\right)$$

Since there is no capital gain element, the yearly payment would consist of the excluded amount and the "interest" element. Under the new six percent tables[106] the ordinary income of the annuitant is limited to six percent.

Rev. Rul. 68-183[107] will be inapplicable to cause taxation of the non-marital family trust's income to W because the grantor of the family trust in our case is not the wife but the deceased husband, and, as to the portion she transferred for the annuity, she is the purchaser from the trust not the grantor. IRC § 677 is inapplicable because it would apply only to the grantor. IRC § 678 would not apply to the widow making her "a person other than the grantor treated as the substantial owner" because if she elects the annuity she has no discretionary power to vest income or corpus in herself under the terms of the will. Since neither Section 677 nor Section 678 applies, no income is chargeable to the surviving spouse.

2. *GIFT TAX*

Since the annuity value equals the fair market value of the property as computed by the commissioner's tables, there is no gift. There is no question of valuation either as the government itself determined the value. The fact that the widow elected not to take under the will cannot create a gift if state law provides, as it does in most states, that an heir can completely refuse the property.[108] Of course, if the widow does not elect, she still has the life income from both trusts and the principal of her marital deduction trust. The plan we are using is very similar to the so-called "widow's election" in community property states.[109]

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[106] Treas. Reg. § 20.2031-10 (1970).

[107] 1968 INT. REV. BULL. No. 16, at 19.

[108] Treas. Reg. § 25.2511-1(c) (1958).

[109] Oregon, California, Nevada, Idaho, Arizona, New Mexico, Texas, and Louisiana all allow valid widow's elections under a widow's election statute where the surviving spouse would exchange a remainder interest in her own property for a life estate in the deceased spouse's property. The net effect of the transfer allows the wife a life estate in the whole community property, while the estate of the deceased husband can distribute the remainder interest in the wife's property. Estate of Lela Barry Vardell, 307 F.2d 688 (5th Cir. 1962); Commissioner v. Mildred Siegel, 250 F.2d 339 (9th Cir. 1957)

Later when cash begins to accumulate beyond a reasonable reserve for immediate needs and emergencies, a steady plan of lifetime gifts can be initiated using the gift tax exclusion and the lifetime exemption of the wife. If only $60,000.00 is left in her estate, there is no estate tax as the estate exemption covers the property.[110] The non-marital-family-trust could provide for contributions to trust for residuary beneficiaries of the cash they received as gifts, in order to provide needed cash to the annuitant, but no obligation to do such should be made.

3. *ESTATE TAX*

If there is no gift initially, Section 2035 cannot come into play since fair and adequate consideration was reserved. Later gifts to children may be within the three year presumption, but a well established pattern of gifts can overcome inclusion under Section 2035. If no security interest is retained IRC § 2037 does not come into play. There is, in addition, no retained life estate because, as to the family trust share, she received full and adequate consideration which bars inclusion under IRC § 2036. Thus even if Rev. Rul. 68-183 implied a life estate merely by finding her the grantor under Section 677, there could be no inclusion because there was full consideration. Technically, as long as *W only has* the unsecured obligation of the trustee, she does not have a life estate in the property. She cannot look to the property for income, but only to the trustees.

Further, the executor is not directed to acquire a terminable interest for the spouse, so the marital deduction is fully allowable.[111] The will should, therefore, specifically state that it is her property and her election to take the annuity.

4. *Summary:* The plan offers a way to obtain the higher lifetime income tax exclusion of Section 72 without either the rapid increase in ordinary income if *W* survives her life expectancy or any gift tax or estate tax.

B. Basic Economic Consequences

1. Assuming that both the marital and non-marital trust are managed by a bank trust department, the widow receives a promise to pay of a fiduciary. The private annuity costs no more than it ordinarily would since the bank handled both trusts anyway. The payments can be made from both the marital share and the non-marital share. If the widow is taking an unsecured promise, it

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110 Int. Rev. Code of 1954, § 2056.

111 Wright v. Commissioner, 28 B.T.A. 543 (1933).

would be preferable to have the bank as the obligor. Moreover, with the bank as fiduciary there is little chance of conflict between the widow and the heirs of any child who died early and were obliged to provide the annuity. The trust survives as an entity so long as the annuitant lives, so there need be no fear of intervening deaths of the obligors. The net amount ultimately distributed by the trust after paying the annuity would equal the amount inherited by the annuitant's heirs if the annuity had not been entered into. If the property transferred was always worth $1,000,000.00, and the annuitant died early after receiving $500,000.00 in cash, then the obligors receive $500,000.00 from the trust and also whatever cash is left in the estate, for example, $100,000.00 for a total of $600,000.00. If the annuitant kept the $1,000,000.00, consuming $400,000.00, then the heirs would receive the same amount—$600,000.00 (less estate taxes of course). By putting the property in trust, the property escapes the probates of the obligor children who die before the annuitant. The estate-skipping trust saves estate taxes caused by the death of any obligor before the annuitant.

Assuming close corporation stock is used to fund the trust, the trust provides impartial control over the family business; it becomes in effect the majority shareholder and the "voting trust" unifying the business. The children will, of course, get large salaries if they stay on as employees because the trustee would desire to get along with the trust beneficiaires. If the property is sold before *W's* death, and the government properly includes some element in the *W's* estate, as where there was a gift element in the transaction and the transfer was in contemplation of death, the basis will not be lost as is usually the case when property is sold before the testator's death *without* being trusteed.[112] If the widow makes cash gifts to the children, they can, in return, turn them over to the trust voluntarily to help pay for the annuity. They will be considered to have made an additional investment of capital in the trust with its accordant result on basis.

2. The widow receives a *guaranteed* income in cash and not assets which are not readily marketable and which require management. The children receive the appreciation in the property and perhaps a bargain purchase if the mother dies early. If she dies late, they receive the same net residue as they would if she had survived without reduction for estate tax. The only one who is disinherited seems to be the commissioner. The commissioner credited *H's* estate with the full marital deduction with the high hopes of picking up the property in the wife's estate. But now he

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[112] INT. REV. CODE of 1954, § 2056(b)(1)(c).

finds that all that is left is the residue of the cash annuity not consumed or transferred by the widow. The commissioner, in large estates, will get some gift tax because the transferor would prefer receiving less of an annuity than the property would produce, but the gift tax will be minor in comparison to the estate tax of one who has no surviving spouse. The widow is taxed on the income she would normally receive from the two trusts and, perhaps in some cases, if the assets transfererd are good producers of income, less income than she would have had if she had kept the assets.

The widow who has a long life purchases guaranteed income without any estate tax on the transferred property. If there is a gift element, the gift tax cost is relatively minor in comparison to the estate tax on a person without a marital deduction. The income tax is limited to a six percent ordinary income element. A private annuity transaction is much better than an installment sale contract with the same heirs because the full value of the contract rights received from the obligation is included dollar for dollar in the estate, whereas there is nothing included in a private annuity transaction without a gift element except cash saved from the private annuity payments.

To exclude the property from her estate, the widow could give all of it away, but she would pay a gift tax. In a private annuity the transaction is at arms length so there is no gift. Further, if the widow returned a life estate, the property would have to be excluded in the estate tax return.

C. How Does the Plan Overcome the Normal Disadvantages of the Private Annuity?

1. *THE PROBLEM OF EARLY DEATH OF THE ANNUITANT*

If the annuitant dies early, then the adjusted basis of the property is very low because the final adjusted basis equals the payments actually made less depreciation. If no sale is intended on non-depreciable property, such as close corporation stock, the lack of a high basis is not a handicap.

If a sale is intended in the future on the non-depreciable property, then either the trust should not be funded with such an asset to avoid the potential low basis problem, or the trust should have provisions guaranteeing a minimal basis. There are two basic approaches either of which alone is good, or they could be combined. If there were a certain number of guaranteed payments, there would be a minimal basis. If the actuarial value of the payments is less than $60,000.00, there is no estate tax on account of the exemption. Furthermore, any additional basis purchased would be

at a low effective estate tax cost. Or the widow could borrow before transferring the property and then have the trustee assume the mortgage and relieve her of liability. When the widow feels the nest egg, or part thereof, is not needed, she can make gifts to reduce her estate and the estate tax. Whether the mortgage is assumed, or taken subject to, there is a minimal basis.[113] Perhaps both of these ideas could be used to provide a minimal basis equal to the initial fair market value of the property at the time of purchase. The mortgaging of property by the widow is not the taking of a security interest by W. She only has the trustee's promise to pay. But the bank will watch the assets more closely because they have their money invested.

If one can duplicate the basis of the property which it would receive on *W's* death if it were left in her estate by obtaining a basis through borrowing and a guarantee, then it is obviously more advantageous to have the annuity. The reason is that there will be little or no estate tax cost, although there would be some income tax cost for the income in respect of a decedent[114] contained in the guaranteed annuity payments. Although there is no basis in income in respect for a decedent,[115] the harsh effect of the income tax on the annuity payments is washed out by spreading them over a number of years and by getting an increased annuity basis in property for the payment thereof.[116] In a case of determining whether to fund a private annuity with property which the taxpayer may sell in the future, one must go through a set of mathematical computations based on the facts in that case. The only conclusion that we can draw from our discussion of the problem is that there need not automatically be a low basis in the transferred property upon the early death of the annuitant. Indeed, by including the property in *W's* estate, it is possible in some cases to get the same basis without any estate tax cost produced.

If close corporation stock were used and the value of such stock was always $1,000,000.00, then if the annuitant died after receiving only $100,000.00, the basis to the transferee would be only $100,000.00. Whereas, if the bank trust department borrowed $500,000.00 from the bank's loan department using the stock as security, then the basis in the stock would be $600,000.00. And if minimal payments of $500,000.00 were also guaranteed, then since there would be $400,-000.00 due the estate, the total basis in the property would always

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113 INT. REV. CODE of 1954, § 1014-3d.

114 Crane v. Commissioner, 331 U.S. 1 (1946).

115 INT. REV. CODE of 1954, § 691.

116 Treas. Reg. § 1.1014 (1957).

equal $1,000,000.00, or the basis the property would have had if it were left in the estate. The six percent "interest" element would be taxed to the estate or the heirs depending upon who received the guaranteed payments. This interest element would be limited to six percent on the new tables and not the dividends from the close corporation stock which go to the trustee. The guaranteed payments could provide cash necessary to pay the estate tax.

The previous example dealt with exclusively non-depreciable property. Naturally, the same techniques of building basis apply to depreciable property, but, for reasons stated later in this article, depreciable property is not the most advantageous item to transfer.

2. *LATE DEATH*

If the widow dies after her life expectancy is up, the trust pays more for the property than a normal purchaser would. In an inter-family transaction, the heirs receive the same net amount they would inherit. Further, the additional payments add to the heirs' basis enabling them to shield further gain or realize a loss.

3. *THE INTEREST DEDUCTION*

Appropriate provision in the instrument designating a certain return as interest would allow the deduction because IRC § 483 (e) (5) covers only those cases where there is no mention of any interest. As discussed previously, the cases have not ruled against an interest deduction when the instrument designates a certain amount of interest. When the trustee borrows from the bank, most of the earlier loan payments are designated interest. Since this interest is deductible, the estate in effect pays off the annuity with the pre-tax dollars.

D. SALE OF PROPERTY FOLLOWED BY EARLY DEATH OF ANNUITANT

If the property is sold early, there is a possibility that income will be recognized years later when the transferor dies by virtue of the fact that the actual payments do not equal the actuarial value of the annuity credited against the amount realized at the time of the prior sale. The gain is reported later and at capital gains rates because the prior transaction was capital in nature.[117] Since we are not dealing with depreciable property, there will be no recapture under IRC §§ 1245 or 1250 and none of the consequent problems of timing and amount reportable.

[117] Arrowsmith v. Commissioner, 344 U.S. 6 (1952).

E. No Loss Deductions to Annuitant's Estate

The annuitant gets no loss deduction if she does not live out her life expectancy because she got what she bargained for, namely, income for life.[118] The result is the same for commercial annuities. The private annuity has an advantage that the commercial annuity does not have—the annuitant's loss is the children's non-taxable gain.

The trust, on the other hand, is dealing only with the widow as an individual and not as a beneficiary, so that the trust's deductions are not disallowed under IRC § 267. If the widow was a beneficiary of the trust, any loss the trust had in making payments would not be deductible under Section 267 (a) (1) and (b) (6).

F. Cash Flow

If the property is substantial, the cash needed to pay off the annuity will be substantial. But a bank's trust department is in a good position to borrow from its loan department, especially with the marital and non-marital property as security in a trust in their own bank. The transaction would provide present cash in line with the trust's needs, and yet give the trust a reasonable time for repayment in line with the trust's income.

G. Double Taxation of Trust Income

If the trust received no deductions for payments made to the annuitant, the income of the trust would be taxed as income of the trust once and again as income of the annuitant. The ideal situation would be to provide trust deductions such as interest or depreciation deductions to match the trust's income so that the effect is to pay the annuity with pre-tax dollars. The annuitant's income is then taxed once. Trust powers should allow for the right to borrow on the transferred property and other trust property as well as for the right to invest in depletable and depreciable property.

H. Valuation of Property Transferred

The valuation in *H's* estate will be made by the commissioner. While that valuation is not conclusive as to fair market value,[119] it certainly is more difficult for the commissioner to contest his own valuation established on audit, and especially when the estate has

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[118] Helvering v. Louis, 77 F.2d 386 (D.C. Cir. 1935).

[119] Treas. Reg. § 1.1014-1 (1957); Rev. Rul. 54-97, 1954-1 Cum. Bull. 113.

a good appraisal. Since the estate has already paid for the appraisal, it does not cost the widow any money to use it.

I. SECURITY

A bank which loans money on assets held in trust makes sure that the loan does not exceed the trust's equity, and that the assets are not dissipated. All children share equally and are treated impartially. No one member of the family gets the benefit of the bargain. If a child was the obligor, and he died early, there undoubtedly would be a scramble for the income between the widowed mother and the wife and minor children. While an unsecured promise of a bank may not be security, it is better than the promise of a child, and the closest thing to security possible. The widow would get no more out of her marital deduction trust.

J. BUILT IN PROFIT GOING TO THE CHILDREN

The children receive, tax free, all appreciation taking place during the payout of the annuity. There is also another surprising profit factor. Under both IRC § 72 and Rev. Rul. 69-74[120] computations, life expectancy is figured using the commercial tables. These tables always have a built-in profit element. Also, if the widow dies early, the children get a tax free profit because they have paid practically nothing for the asset.

K. WOMEN UNDER THE ANNUITY TABLES

The tables used in the discussion in the first part of this article were based on a man's life expectancy. This was done so that the factual situation covered in Rev. Rul. 69-74 which involved a man could be analyzed using the three and one-half percent and the six percent tables under two sets of contingencies—an open transaction and a closed transaction. With the promulgation of Treas. Reg. § 20-2031-10 (1970), which distinguishes between men and women, a different set of computations has to be made for women under the new six percent tables. Attached to the tables in the appendix to this article is a section called "Explanation of Private Annuity Computation," Sub-section 3 of the discussion covers the difference between men and women as a result of the new tables. These results are verified by a careful examination of the new estate tax tables themselves.[121] On the same facts used in my own tables at the back

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120 1969-1 CUM. BULL. 43.

121 See the tables contained in Treas. Reg. § 20.2031-10 (1970).

of this article, my computations[122] show between a ten and eleven percent variation in the exclusion ratio which would produce between ten and eleven percent more ordinary income. However, the longer life expectancy reduces any gift made and the amount includible in the estate because of that gift. The gift and estate taxes are thus reduced. An examination of the six percent tables shows that as men and women get older, the differences in annuity factors becomes minimal. The differences just mentioned will not affect our hypothetical because we are dealing with the maximum tax savings to a woman, and any other plan would have to use the same tables or adopt a completely different technique which would have a difficult time matching the economic and tax advantages of the private annuity.

L. Testing the Plan

To date there are very few reported private annuity cases and none testing this plan. In order to provide absolute security, perhaps it would be wise to apply for a ruling. The government has declared Rev. Rul. 239[123] dead under the 1954 Code.[124] Thus its holding of no rulings in the private annuity area would no longer stand. The government would have to apply Rev. Rul. 69-74 to our facts and the taxpayer would effectively be getting the same results as under Section 72 because the adjusted basis of the property equals its fair market value.

Since the results as to the transferor's income tax are the same whether the transaction is open or closed, there is little litigation potential in the case for the government. There is no gift and the estate tax consequences of a private annuity have been well set in case law.

IX. SOME ADDITIONAL PROBLEMS

We have covered the basic plan; now let us cover some additional points and variations.

A. Additional Losses

While it is true that the transferor gets no loss under IRC § 165,

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122 Using our facts the exclusion ratio for a woman of 74 would be lower:

$$55\% \quad \left(\frac{6.7645 \times 7200 \times 1.0272}{12.6 \times 7200}\right)$$ versus a 65.6% exclusion ratio for a man.

A woman would have less income excluded and thus would pay more tax on ordinary gross income $(65.6\% - 55\% = 10.6\%)$.

123 1953-1 Cum. Bull. 352.

124 *See generally* Rev. Rul. 69-74, 1969-1 Cum. Bull. 43.

if the payments do not equal the payments to be expected if she survived to the end of her life expectancy, it is not true that the trust cannot take the losses resulting from paying more than they realize from the asset. As long as the widow is not a beneficiary of the family trust, IRC § 267 cannot deny the losses to the trust.[125] Since the widow and not the trustee of the marital trust elected the annuity, Section 267 would not bar the loss because of a transaction between two trusts of the same grantor.[126] The problem arises when one realizes that, under Section 267(b)(7), losses are denied when the transaction is between a fiduciary of a trust and a beneficiary of another trust of the same grantor. If the transaction is considered between the beneficiary of the marital trust and the trustee of the family trust, Section 267(b)(7) and Section 267(a)(1) would bar the loss. However, when the widow elects the annuity, she uses her general power of appointment and destroys the marital trust. She then enters upon a separate transaction with the family trust. The widow is no longer a beneficiary of the marital trust, thus the later losses to the trustee of the family trust on the private annuity are allowable. These losses can be used against gains of the whole family trust which now is the whole estate.

B. Use of Depreciable Property to Fund the Annuity

If the trust receives no depreciable property, the trustee will pay the annuitant with taxed dollars. If, however, depreciable property with an IRC § 1014 basis is transferred, the large depreciation deductions allow payment of the annuity with pre-tax dollars, and therefore it seems better to use depreciable property. In my opinion, depreciable property is not the most favorable asset to transfer. First of all, the widow can use the depreciable property to shield her ordinary income, while the trust can use the interest on the mortgage assumed from the widow as well as the interest on the trust's own additional borrowings to shield the trust's income. It may be possible to pass the income to the widow free of tax on the trust level or on the individual level. Generally, depreciable property needs active management, and perhaps it would be better to keep the real estate out of the trust and have a broker manage it for the widow. Secondly, if depreciable property is in the trust on the widow's death, it does not get an increased basis under Section 1014. For the same amount of estate tax, the heirs could get additional depreciation to shield their income later on, or to cut their gain. Ultimately, the depreciable property will be sold, and at that

125 Int. Rev. Code of 1954, § 267(a)(1) and (b)(4).

126 Int. Rev. Code of 1954, § 267(b)(5).

point the increased basis will be very helpful. Further, if the trust realizes any gain on the sale of the depreciable property, there is very little authority informing the trustee how to report the ordinary income from recapture. If the property is sold, and the widow dies soon thereafter, the estate may realize additional income because of prior depreciation when the annuity payments do not equal the actuarial value of the future payments credited against the amount realized in the initial sale. The trustee is thus faced with difficult recapture computations and allocations. Thirdly, the trust could use other depreciation and depletion deductions against the transferred properties' income. Sometimes, if non-depreciable property such as close corporation stock is used, the amount of income receivable in any one year through dividends is controllable. The trust itself may be the real majority shareholder. For the three previously stated reasons, it is my belief that non-depreciable property (when available) is the better asset to transfer.

C. Use of Partial Gifts and Partial Sales in Private Annuity Transactions

In all previous discussions we have assumed that there was no gift element. Suppose the value of the property is substantial, the widow has no need for the cash, and the obligor has no readily available cash in sufficient amount to meet the necessary demands of the annuitant. Instead of using a pure annuity, it is possible to have a partial purchase of an annuity coupled with a gift. Under Rev. Rul. 69-74 the resultant gift element equals the difference between the fair market value of the property and the present actuarial value of the annuity payments under the estate tax tables. The transferee does not have to have cash available, the annuitant satisfied her needs, and the gift may still be kept out of the estate if it is not in contemplation of death. A partial gift—partial sale involves two hidden risks in the eyes of commentators.

According to one commentator,[127] there may be a variation between the basis for the tranferred property under Treas. Reg. § 1.1015-4 (1957) and Rev. Rul. 55-119[128] other than the adjustment for gift tax paid.[129]

The basis under Rev. Rul. 55-119 is the sum of the basis for the gift and for the annuity. The basis for the gift is the donor's adjusted basis less the present value of the annuity. The gift basis

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[127] Ellis, 195 T.M. (B.N.A.) *Private Annuities.*

[128] 1955-1 Cum. Bull. 352.

[129] Int. Rev. Code of 1954, § 1015(d).

can never go below zero. The basis for the annuity is the actuarial value of the future payments. The total of these two bases is the basis for the transferred property. The basis under Treas. Reg. § 1.1015-4, which was promulgated after Rev. Rul. 55-119, is the greater of the adjusted basis of the donor or the amount paid for the property plus the gift tax paid adjustment under IRC § 1015 (d). In the case of loss, the basis of the property can never exceed the fair market value of the property transferred. Despite the different methods of computation, Footnote 72 proves that the basis for gain or loss is the same under Rev. Rul. 55-119 as under Treas. Reg. § 1.1015-4. Since the basis for depreciation is the same as the basis for gain,[130] the basis for depreciation under the ruling and the regulation is the same. The proof further shows that the gift tax adjustment of Section 1015(d) does not affect the equality of the two bases.

The other hidden risk is a real danger. For if the gift is included in the estate, the estate inclusion may be more than the value of the gift. IRC § 2035 requires inclusion of the value of the property on the date of death. IRC § 2043 only credits the value of the annuity *at the date of the transfer* against the inclusion. The appreciation in the property would all go into the estate. Thus if a hidden gift of one dollar were found, the appreciation in the property would be included. The risk is so substantial that it may be better to give the widow all the cash from an annuity whose present value equals the fair market value of the property and then have her make gifts. One would think that the gifts would be included to the same extent as when a partial gift—partial sale is made, but this is not true. Only the value of the actual cash transferred as gifts would go into the estate; whereas, in a partial gift—partial sale situation the cash value of the gift plus the appreciation between the transfer and the date of death is included. I prefer later gifts back because the widow herself can judge her needs better later on, and cash gifts can get the three thousand dollar per year gift tax exclusion.

There is an even simpler way to reduce the annuity obligation. The widow could mortgage the property, obtaining cash, then transfer the property with the mortgage to the trust having the trust assume the mortgage and free her of liability. Later, gifts could be made from the retained cash to the children who could use the cash to help the trust pay off the annuity obligation or who could probably use the cash in raising their children.

130 Treas. Reg. § 1.167(g) (I), T.D. 6712, 1964-1 CUM. BULL. 106.

D. Use of Private Annuity in Situations Where There Is A Charitable Remainder Desired

Prior to the Tax Reform Act of 1969,[131] it was not uncommon to see a testamentary trust created with a life estate going to a widow coupled with a limited power of invasion, say for health, maintenance and support, with a remainder over to a charity. The Treasury would allow a full charitable deduction for the value of the remainder to a charity despite the fact that the charity may receive nothing as long as the possibility that the corpus will be invaded is "so remote as to be negligible"[132] and as long as the charitable interest is computable.[133] The estate would claim the widow has no need for the money and that the remainder going to the charity was calculable and thus deductible. Under the Tax Reform Act of 1969, this device was curtailed by the requirement that there be no power of invasion.[134] The charitable trust which has a life interest going to an individual other than a charity can only take three forms to qualify the estate's charitable deductions: (1) a charitable remainder annuity trust,[135] (2) a charitable remainder unitrust,[136] or (3) a guaranteed annuity.[137]

Each one of these forms limits the invasions of the widow who may ultimately need the principal. There is a way to use a private annuity to give a qualifying gift to charity, to allow the widow security by allowing her to use corpus, and at the same time, to give an increased basis to the trust for the transferred property so that the property will not have a low basis on the early death of the annuitant. Suppose the widow mortgaged the property for an amount equal to the desired charitable gift before the property was transferred to the trust and that the trust then assumed the mortgage and paid the widow the cash she needed to live on. If she needed more she could look to the original nest egg for help. The trust would get added basis because of the purchase money mortgage, and that basis would prevent a low basis in event of death. The widow could bequeath the fund directly to charity on her death and get the full deduction under IRC § 2055. Her estate would be reduced by the amount of the charitable deduction to

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131 Tax Reform Act of 1969, 26 U.S.C. §§ 1 *et seq.*

132 Treas. Reg. § 20.2055-2(b) (1958).

133 Treas. Reg. § 20.2055-2(a) (1958).

134 Int. Rev. Code of 1954, § 2055(e) (2).

135 Int. Rev. Code of 1954, § 664(d) (1).

136 Int. Rev. Code of 1954, § 664(d) (2).

137 Int. Rev. Code of 1954, § 2055(e) (2) (B).

zero, the trust would have a guaranteed basis in the property, and the widow would have a security during her life.

The plan can be improved upon even further by mortgaging the property for the value of the charitable gift expected to be made plus $60,000.00. The widow gets even more security. The charity would probably get the full gift because the widow had the $60,000.00 to look to. The widow's estate would pay no estate tax because of the charitable deduction and the exemption. And finally, the trust gets an even larger basis on account of the greater amount of the purchase money mortgage assumed.

E. Stock Redemption Plan and Private Annuities

Should the trust get the widow's close corporation stock redeemed, there could not be a complete redemption under IRC § 302 (b) (3) because the children hold shares in the company. The family attribution rules of IRC § 318 will not be waived unless the children are no longer officers of the corporation.[138] Avoiding the attribution rules of Section 318 is unlikely unless the children sell; there is a substantially disproportionate redemption under IRC § 302 (b) (2); or the distribution is not "essentially equivalent to a dividend." All of these possibilities may not be feasible since the children are in the corporation as shareholders, and the earnings and profits of the corporation are substantial.

The best bet is to wait and let the children redeem the stock. The children lose no control. The trust could gain the cash needed by borrowing from the controlled corporation, the children or a bank. If the interest deduction is desired, IRC § 267 (a) (2) will not bar it by reason of the fact that the borrowing is from the close corporation because the interest deduction is lost only when it is unpaid for two and one-half months after the close of the trust's taxable year, when the trust is a cash basis trust and the corporation is accrual basis.

F. Borrowing from the Close Corporation

It may be possible for the trust to use free cash in the corporation to finance the annuity without having to borrow at high interest rates. As was noted in the previous paragraph, Section 267 (a) (2) will not bar the interest deduction to the trust. The trust can get free cash to pay the annuitant, and can take an interest deduction, thus paying the annuitant with tax-free dollars, and yet it can

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138 Int. Rev. Code of 1954, § 302 (c) (2).

pay a reasonable interest rate to the controlled corporation. The children, in the end, gain more because they still have the interest that would normally be paid to the bank.

G. Short Life Expectancy of the Annuitant

If the annuitant has a significantly shorter life expectancy than that under the tables, the government may find a hidden gift. Taxpayers have had considerable success in persuading the courts to disregard the tables,[139] and there is no reason why the commissioner cannot do the same. He has already held the tables inapplicable due to the poor health of the individual in an analogous situation not involving private annuities.[140]

In doubtful situations, the employment of an independent actuary may be necessary. Further, to be completely sure that there is no gift, an appraisal by a qualified appraiser should be procured. Medical evidence concerning the health of the annuitant should also be gathered. Careful planning of cash flow should be made for the trust so that appropriate mortgages can be arranged without straining the trust or the children.

X. EFFECT OF FUTURE CHANGES IN THE LAW

If the Treasury is successful in denying basis for mere inclusion in an estate, or requires a reporting of taxable gain by the estate before basis is given, then there will be no advantage in including the property in the widow's estate, and private annuities will become very popular. The husband who has a large estate consisting of low basis assets may try a private annuity himself to avoid inclusion.

Under the hypothetical it made no difference whether the transaction was open or closed because the income tax results were the same. However, in other plans it may make a difference and the commissioner will probably attempt to reinforce his closed transaction theory with legislation. We may see proposed legislation similar to IRC § 1241 which was proposed before the House of Representatives in 1954 and again in 1963.[141]

The only potential danger to our hypothetical is the determination that it involves the retention of a life estate. Professor

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139 Estate of Butler v. Commissioner, 18 T.C. 914 (1952).

140 Rev. Rul. 66-307, 1966-2 Cum. Bull. 429.

141 H.R. Rep. No. 8300, § 1241, 83d Cong., 2d Sess. 541 (1954).

Lowndes has suggested this very result,[142] but as of this date the law and the cases draw a distinction between a *guaranteed payment*, founded upon a personal contractual obligation which is payable in all events, from a *life estate* which requires the life tenant to look only to the contingent income from the property.

Employment of the hypothetical seems to promise everything to gain and nothing to lose. If the transferred property appreciates, the appreciation goes to the children, and if the property depreciates, the widow gets a guaranteed income from the whole estate. The children receive economically the same interest they would have received by bequest, namely, the total property less widow's living expenses, with as little tax bite as possible.

An unusual opportunity for planning exists once the family has decided the benefits listed above are indeed available. The new six percent tables would allow a greater amount of the widow's estate to escape estate tax, and also reduce the value of any potential gift. Further, if there is no gift element involved, there will be nothing included in the widow's estate where all her marital deduction property is exchanged for a private annuity. The husband's estate gets the benefit of the marital deduction without ever having anything included in the wife's estate.

APPENDIX

TABLES

I. Treatment of Private Annuities Under Rules of INT. REV. CODE of 1954, § 72 using the Commissioners 3½% Actuarial Tables—Treas. Reg. § 20.2031-7 (1958).

II. Treatment of Private Annuity Under Rules of INT. REV. CODE of 1954, § 72 using Commissioner's 6% Actuarial Tables.

III. Treatment of Private Annuity Under Rev. Rul. 69-74, 1969-1 CUM. BULL. 43 using Commissioner's 3½% Actuarial Tables.

IV. Treatment of Private Annuity Under Rev. Rul. 69-74, 1969-1 CUM. BULL. 43 using Commissioner's 6% Actuarial Tables.

V. Explanation of Private Annuity Computations.

A. Basic Factual Assumptions.

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[142] Lowndes, *Consideration and the Federal Estate and Gift Taxes: Transfers for Partial Consideration, Relinquishment of Marital Rights, Family Annuities, The Widow's Election, and Reciprocal Trusts*, 35 GEO. WASH. L. REV. 50 (1967)

B. Notes on Computation.

C. Some Observations For Future Reference.

I

TREATMENT OF PRIVATE ANNUITY UNDER RULES OF SEC. 72 USING COMMISSIONER'S 3½% TABLES— TREAS. REG. § 20.2031-7 (1958)

Year	Total Receipt	Exclusion Ratio - 65.6% Exempt § 72 (b)	Capital Gain	Ordinary Income
1	$7,200.00	$4,723.20	$ – 0 –	$2,476.80
2	7,200.00	4,723.20	– 0 –	2,476.80
3	7,200.00	4,723.20	– 0 –	2,476.80
4	7,200.00	4,723.20	– 0 –	2,476.80
5	7,200.00	1,107.20	3,616.00	2,476.80
6	7,200.00	– 0 –	4,723.20	2,476.80
7	7,200.00	– 0 –	4,723.20	2,476.80
8	7,200.00	– 0 –	4,723.20	2,476.80
9	7,200.00	– 0 –	4,723.20	2,476.80
10	7,200.00	– 0 –	4,723.20	2,476.80
11	7,200.00	4,242.12	481.08	2,476.80
12	7,200.00	4,723.20	– 0 –	2,476.80
	Indefinite	Indefinite	– 0 –	Indefinite

II

TREATMENT OF PRIVATE ANNUITY UNDER RULES OF SEC. 72 USING COMMISSIONER'S 6% TABLES

Year	Total Receipt	Exclusion Ratio - 60.4% (2) Exempt § 72 (b)	Capital Gain	Ordinary Income
1	$7,200.00	$4,348.80	$ – 0 –	$2,852.20
2	7,200.00	4,348.80	– 0 –	2,852.20
3	7,200.00	4,348.80	– 0 –	2,852.20
4	7,200.00	4,348.80	– 0 –	2,852.20
5	7,200.00	2,604.80	1,744.00	2,852.20
6	7,200.00	– 0 –	4,348.80	2,852.20
7	7,200.00	– 0 –	4,348.80	2,852.20
8	7,200.00	– 0 –	4,348.80	2,852.20

9	7,200.00	– 0 –	4,348.80	2,852.20
10	7,200.00	– 0 –	4,348.80	2,852.20
11	7,200.00	3,925.48	423.32	2,852.20
12	7,200.00	4,348.80	– 0 –	2,852.20
	Indefinite	Indefinite	– 0 –	Indefinite

III

TREATMENT OF PRIVATE ANNUITY UNDER REV. RUL. 69-74, 1969-1 CUM. BULL. 43, USING COMMISSIONER'S 3½% TABLES—TREAS. REG. § 20.2031-7 (1970)

Year	Total Receipt	Exclusion Ratio - 60.4% Exempt § 72(b)	Capital Gain	Ordinary Income
1	$7,200.00	$1,980.00	$2,743.87	$2,476.13
2	7,200.00	1,980.00	2,743.87	2,475.13
3	7,200.00	1,980.00	2,743.87	2,476.13
4	7,200.00	1,980.00	2,743.87	2,476.13
5	7,200.00	1,980.00	2,743.87	2,476.13
6	7,200.00	1,980.00	2,473.87	2,476.13
7	7,200.00	1,980.00	2,743.87	2,476.13
8	7,200.00	1,980.00	2,743.87	2,476.13
9	7,200.00	1,980.00	2,743.87	2,476.13
10	7,200.00	1,980.00	2,743.87	2,476.13
11	7,200.00	1,980.00	274.38	4,945.62
12	7,200.00	1,980.00	– 0 –	5,220.00
	Indefinite	Indefinite	– 0 –	Indefinite

IV

TREATMENT OF PRIVATE ANNUITY UNDER REV. RUL. 69-74, 1969-1 CUM. BULL. 43, USING COMMISSIONER'S 6% TABLES

Year	Total Receipt	Exclusion Ratio - 27.5% Exempt § 72(b)	Capital Gain	Ordinary Income
1	$7,200.00	$1,980.00	$2,367.46	$2,852.54
2	7,200.00	1,980.00	2,367.46	2,852.54
3	7,200.00	1,980.00	2,367.46	2,852.54
4	7,200.00	1,980.00	2,367.46	2,852.54
5	7,200.00	1,980.00	2,367.46	2,852.54
6	7,200.00	1,980.00	2,367.46	2,852.54

7	7,200.00	1,980.00	2,367.46	2,852.54
8	7,200.00	1,980.00	2,367.46	2,852.54
9	7,200.00	1,980.00	2,367.46	2,852.54
10	7,200.00	1,980.00	2,367.46	2,852.54
11	7,200.00	1,980.00	236.72	4,983.28
12	7,200.00	1,980.00	-0-	5,220.00
	Indefinite	Indefinite	-0-	Indefinite

V

EXPLANATION OF PRIVATE ANNUITY COMPUTATIONS:

A. BASIC ASSUMPTIONS—We are working with the same factual situation presented in Revenue Ruling 69-74. Thus we have a man aged 74 who transfers appreciated property with an adjusted basis of $20,000 for a private annuity payable for life at the rate of $600 at the end of each month.

Four alternatives are considered:

I. Computation is made on the character and amount of income received using the rules set out in Rev. Ruling 69-74 and using the old 3½% tables in Treas. Reg. § 20.2031-7(f) (1958).

II. The same computation is made under Rev. Rul. 69-74 but using 6% tables under new regulations.

III. Computation is made on the character and amount of income received using the rules set out in IRC § 72 and using the 3½% tables in Treas. Reg. § 20.2031-7(f) (1958).

IV. The same computation is made under Section 72 but using 6% tables under the new regulations.

B. NOTES ON COMPUTATIONS:

(1) A.B.=$20,000=Investment in the contract
Expected Return=10.1 life expectancy* x $7,200=$72,720

Exclusion Ratio under Rev. Ruling 69-74 $=\frac{20{,}000}{72{,}720}=27.5\%$

* The life expectancy is taken from Treas. Reg. § 1.72-9 (1957), Table I, which was not changed under proposed regulations because it already was the modernized table used by insurance companies.

Notice that under Rev. Rul. 69-74 that the lifetime exclusion ratio is constant when the life expectancy is unchanged. This is a concomitant result of considering the investment in the contract equal to the adjusted basis of the appreciated property.

(2) Investment in the contract=FMV of annuity=
$600.00 x 1.0272* x 5.9373**=$43,911.32

Expected Return—10.0 life expectancy x $7,200.00=$72,720

Exclusion Ratio per Sec. 72= $\frac{43,911.32}{72,720}$ =60.4%

(3) Amount Realized=43,911.32
AB =20,000.00

Total Capital Gain=$23,911.32
Life Expectancy=10.1 years
Amount Reportable per Year=$2,367.46

C. SOME OBSERVATIONS FOR FUTURE REFERENCE

A) Under the method of computation of Rev. Ruling 69-74:

(1) *FOR MEN*—The new tables reduce the capital gain element because of a reduction in the man's annuity factor. Thus the ordinary income element is increased for a man during his life expectancy.

(2) *FOR WOMEN*—The new tables increase the capital gain element because of the increase in a woman's annuity factor. Thus the ordinary income element is decreased for a woman during her life expectancy.

(3) After both men and women have survived their life expectancies, there is an equivalent rapid rise in the amount of ordinary income reportable because there is no more capital gain to report.

B) Under the method of computation used in Section 72:

(1) *FOR MEN*—The reduction in the exclusion ratio produced by a smaller value of the annuity under the new tables increases the amount of ordinary income reportable throughout the whole life of the individual.

* This factor is due to the fact that the $600.00 payment is to be made at the end of the month. It is taken from Proposed Regulation (now incorporated into the regulations) 20.2031-10(b)(2).

** Factor is taken from new Regulations Table A (1), the table for men. The annuity factor is 5.9373. This is *less* than that used in older regulations for all sexes. The factor in the older table (20.2031-7(f), Table I) was 6.5231. Thus the new tables may reduce the exclusion ratio for men under the computations using Sec. 72 by reducing the investment in the contract. Since the investment in the contract is always the adjusted basis under Rev. Rul. 69-74, that exclusion ratio remains the same.

(2) *FOR WOMEN*—The increase in the exclusion ratio produced by a larger FMV of the annuity under the new tables decreases the amount of ordinary income reportable throughout the whole life of the individual.

D. MAJOR DISTINCTIONS IN METHODS OF COMPUTATION:

(1) The IRS considers a private annuity a closed transaction and requires immediate reporting of a ratable portion of the capital gain each year. This is very similar to the installment method except that the capital gain is reported over the life expectancy. Of course, early death will cause gain to be reported before basis is recouped.

On the other hand, under Section 72, the capital gain is never reported before the basis is recouped. Early death will not cause reporting of non-existant gain.

(2) Rev. Rul. 69-74 produces a tremendous increase in ordinary income if the person out lives his or her life expectancy; while Section 72, due to its higher lifetime exclusion ratio, has no such sudden increment in ordinary income at a time when an individual is least able to afford the additional income tax liabilities.

MATHEMATICAL PROOF FOR FOOTNOTE 72

Proposition: Assuming no gift tax adjustments are involved and there is no such thing as negative basis for a property interest, then the basis of the transferred property for gain and loss and depreciation is the same under Treas. Reg. § 1.1015-4 (1963) as it is under Rev. Rul. 55-119.

Notation: Let the present value of annuity on initiation of the contract equal PV.

Let the transferor's basis on the transferred property be AB_T.

Let the transferee's basis on the newly acquired property be X.

I. In gain situations or where neither gain nor loss is recognized on the property on subsequent sale the proof is as follows:

1. There are (3) possibilities: $PV > AB_T$; $PV < AB_T$; or $PV = AB_T$.
2. If $PV > AB_T$ then the § 1015 basis is greater. $X = PV$ and the Rev. Rul. 55-119 basis is as follows:

A. On gift element: $AB_T - PV < O$ because $PV > AB_T$. Adjusted basis for the gift element is (0).

B. On annuity element: The adjusted basis is its present value or PV.

C. Total: $PV + (0) = PV$.

D. Conclusion: § 1015 basis equals the basis under Rev. Rul. 55-119.

3. If $PV < AB_T$ then the § 1015 basis is greater. $X = AB_T$ and the Rev. Rul. 55-119 basis is as follows:

   A. On gift element: $AB_T - PV > 0 \therefore$ basis for gift element is $AB_T - PV$.

   B. On annuity element: The adjusted basis in the annuity element is its present value or PV.

   C. Total: $(AB_T - PV) + PV = AB_T$.

   D. Conclusion: § 1015 basis equals the basis under Rev. Rul. 55-119.

4. If $PV = AB_T$ then the § 1015 basis is the greater—either AB_T or PV.

   And the Rev. Rul. 55-119 basis is as follows:

   A. On gift element: $AB_T - PV = 0$ since $AB_T = PV$

   B. On annuity element: Adjusted basis is its present value or PV.

   C. Total: $0 + PV = PV$ or AB_T since $AB_T = PV$

   D. Conclusion: § 1015 basis is the same as the Rev. Rul. 55-119 basis.

5. Conclusion: Where gain is recognized or where neither gain nor loss is recognized the basis under Treas. Reg. § 1.1015-4 is the same as the basis under Rev. Rul. 55-119.

II. In loss situations on later sale of the property the proof is as follows:

1. The same three possibilities exist: namely, (a) $PV_T > AB$; (b) $PV < AB_T$; or (c) $PV = AB_T$.

2. In situations (a) and (c), PV could never exceed the FMV of the property figured on the date of the exchange because if it did the children would be making gifts to the mother and not vice versa. This is contrary to the assumption of a gift being made by the mother to the children. The basis

under Treas. Reg. § 1.1015-4 for loss purposes would be PV (X=PV). This result is the same under Rev. Rul. 69-74.

3. In alternative (b) the situation is slightly more complex. For our proof we must add the following notation—let the fair market value of the property at time of transaction be FMV_I.

Either of two situations can be present:

(1) $PV < AB_T \leq FMV_I$ or (2) $PV < FMV_I < AB_T$.

The chart of the results in figuring loss basis under the ruling is as follows:

	Treas. Reg. § 1.1015-4	Rev. Rul. 55-119
(1) $PV < AB_T \leq FMV_I$	AB_T	AB_T
(2) $PV < FMV_I < AB_T$	FMV_I	FMV_I[1]

[1] Using the formula provided in Rev. Rul. 55-119 under item "(e)":

a. Gift element: $FMV_I - PV$

b. Annuity element: PV

c. Total: $FMV_I - PV + PV = FMV_I$

Thus in alternative (b) the adjusted basis for loss is the same under Regs. 1.1015-4 and Rev. Rul. 55-119.

III. Since there can be no other possible situations other than recognition of gain, recognition of loss, or no recognition of gain or loss, then the basis provided under the ruling and the regulation is the same when one does not consider the gift tax adjustments under § 1015. When one considers the gift tax paid adjustments under Section 1015 (d) in regard to the basis under the ruling and the regulation, the final basis is the same because the bases *unadjusted* for the gift tax paid are the same.

Conclusion: There is no real difference between the basic computations under the regulation or the ruling for gain or loss. And since the depreciation basis under Treas. Reg. § 1.161 (g)-1 is the same as the gain basis, the depreciation basis is always the same.