

1-1-1974

## Private Annuities: Closed Transactions?

Jeffrey S. Tanen

Follow this and additional works at: <https://repository.law.miami.edu/umlr>

---

### Recommended Citation

Jeffrey S. Tanen, *Private Annuities: Closed Transactions?*, 28 U. Miami L. Rev. 445 (1974)  
Available at: <https://repository.law.miami.edu/umlr/vol28/iss2/7>

This Case Note is brought to you for free and open access by the Journals at University of Miami School of Law Institutional Repository. It has been accepted for inclusion in University of Miami Law Review by an authorized editor of University of Miami School of Law Institutional Repository. For more information, please contact [library@law.miami.edu](mailto:library@law.miami.edu).

substantive law and statute of limitations.<sup>42</sup> Nevertheless, the *Steele* case reflects an ingenious solution to the problem presented by inconsistent standards of due process applicable to the exercise of state court jurisdiction. By adding a fairness requirement to the territorial requirements of *Harris* and *Hanson*, the court utilized apparently conflicting precedents to synthesize a new rule of due process. Without abandoning basic principles of state territorial sovereignty, this new rule for quasi in rem jurisdiction marks a significant step toward a standard which truly reflects considerations of substantial justice and fair play.

DENNIS J. LEWIS

### PRIVATE ANNUITIES: CLOSED TRANSACTIONS?

Decedent and his wife transferred appreciated stock in two closely held corporations to their children and respective spouses who in exchange, promised to make monthly annuity payments to decedent and his wife for their joint lives. As security for the payments, the stock was placed in escrow and a cognovit note was executed which provided for judgment against the children in case of non-payment. Payments were received in 1968 and 1969 pursuant to the annuity agreement. The annuitants treated these payments as a return of their investment and paid no federal income tax on them. The Commissioner of Internal Revenue determined deficiencies in the annuitants' federal income taxes for 1968 and 1969, treating the annuity payments received as prescribed by Revenue Ruling 69-74.<sup>1</sup> Applying the provisions of Revenue Ruling 69-74, the Commissioner found that decedent and his wife realized an immediate capital gain on the transfer of the property and as the annuity payments were received they were required to recognize that gain on a

---

of the attached debt far exceeded the plaintiff's claim, there was no need to decide that question.

42. See 483 F.2d at 349 n.26. The instant case was instituted in Mississippi in order to take advantage of a longer statute of limitations. *Id.*

1. 1969-1 CUM. BULL. 43 [hereinafter referred to as Revenue Ruling 69-74] in pertinent parts provides as follows:

(1) The gain realized on the transaction is determined by comparing the transferor's basis in the property with the present value of the annuity . . . .

. . . .  
(3) The gain should be reported ratably over the period of years measured by the annuitant's life expectancy and only from that portion of the annual proceeds which is includable in gross income by virtue of the application of section 72 of the 1954 Code . . . .

(4) The investment in the contract for purposes of section 72 of the 1954 Code is the transferor's basis in the property transferred . . . .

After the capital gain . . . has been fully reported, subsequent amounts received (after applying the exclusion ratio) are to be reported as ordinary income.

pro-rata basis over their expected joint lives as actuarially determined. Furthermore, the annuitants' investment in the annuity contract was the basis of the property transferred, not its fair market value as they had contended. On petition, the United States Tax Court held:<sup>2</sup> Revenue Ruling 69-74 does not apply to *secured* private annuities;<sup>3</sup> rather the entire capital gain realized from the transfer of property is immediately recognized in the year the appreciated property is transferred. *Estate of Lloyd G. Bell*, 60 T.C. 469 (1973).

Prior to the present case and to Revenue Ruling 69-74, a transferor-annuitant received favorable capital gain treatment when he transferred appreciated property for an *unsecured* private annuity.<sup>4</sup> Thus in *J. Darsie Lloyd*,<sup>5</sup> the court adopted the principle expressed by the Supreme Court in *Burnett v. Logan*,<sup>6</sup> that when property is transferred for a promise to pay an uncertain amount in the future,<sup>7</sup> the promise has no determinable fair market value (the transaction remains open) and the "amount realized" within the meaning of former section 111<sup>8</sup> (determination of gain or loss on the transfer) must be determined on a payment-by-payment basis. This principle was expanded in the private annuity case of *Hill's Estate v. Maloney*<sup>9</sup> which held that the gain should be taxed after payments received equalled cost basis of the transferred property. Both these decisions were adopted in Revenue Ruling 239.<sup>10</sup>

Based on these authorities, the following principles evolved under the Internal Revenue Code of 1939 as to the treatment of unsecured private annuities:

2. The court adopted neither the view of the petitioner nor that of the commissioner, but set its own guidelines for the treatment of secured private annuities.

3. In view of the *secured* promise, it is interesting to note that the court even treated the transaction as a private annuity. In *Estate of Cornelia B. Schwartz*, 9 T.C. 229 (1947), *acquiesced in*, 1947-2 CUM. BULL. 4, a transfer of property to a trust as security for annuity was held to be a transfer with a retained life interest; likewise where sale of the transferred property was subject to restrictions. *Estate of Pamela B. Holland*, 1 T.C. 564 (1943). Although the court did not direct its inquiry to this question, the mere fact that it treated the transaction as an annuity, rather than as a § 2036 transfer with a retained life interest, lends some weight to the proposition that the question will be decided in favor of an annuity.

While there is no authority which directly states that the promise must be unsecured, the majority of writers indicate that it must. See Middleditch, *Mechanics of the Private Annuity as an Estate Planning Device*, 15TH ANN. TUL. TAX INST. 469 (1965); Raiborn & Watkins, *Critical Analysis of Private Annuity Taxation*, 50 TAXES 11 (1972); Weinberg, *The New Case for Private Annuities*, 51 NEB. L. REV. 9 (1971).

4. *J. Darsie Lloyd*, 33 B.T.A. 903 (1942), *acquiesced in*, 1950-2 CUM. BULL. 3.

5. *Id.*

6. 283 U.S. 404 (1931).

7. The fair market value of the promise in a private annuity is uncertain because it is unsecured. There is no assurance that the obligor-transferee will be able to make the periodic payments. See note 4 *supra*. The uncertain life-span of the annuitant is also a factor. *Estate of Bertha F. Kann*, 174 F.2d 357 (3d Cir. 1947).

8. INT. REV. CODE OF 1939. This section has been superseded by INT. REV. CODE OF 1954, § 1001, which is substantially the same.

9. 58 F. Supp. 164 (D.N.J. 1944).

10. 1953-2 CUM. BULL. 53.

(1) All payments received, excluding the ordinary income portion,<sup>11</sup> were first allocated as a return of capital until the taxpayer's basis in the transferred property was recovered;<sup>12</sup>

(2) all subsequent payments received, excluding the ordinary income portion, were recognized as capital gain until the total payments so treated equalled the excess of the fair market value of the property transferred over its adjusted basis;<sup>13</sup> and

(3) after recognition of the entire capital gain, payments received were ordinary income.<sup>14</sup> (Under the 1954 Code such payments are treated as partly ordinary income, partly tax-free.)<sup>15</sup>

This "open-transaction" treatment was favorable to the transferor-annuitant because he was assured recovery of his basis in the transferred property before recognizing capital gain. The transaction remained "open" after recovery of basis, as the capital gain was realized and recognized on a payment-by-payment basis.<sup>16</sup> With the adoption of the Internal Revenue Code of 1954, the open-transaction approach remained essentially unchanged.<sup>17</sup> Further, under the open-transaction approach the transferor-annuitant was allowed to use the fair market value of the property transferred as his investment in the annuity contract. This treatment allowed inclusion of the unrealized capital gain in the exclusion ratio computation, with the result that the annuitant's ordinary income portion of the annuity payments received were lower than they would have been had the unrealized gain not been included.<sup>18</sup>

Revenue Ruling 69-74 reflected a significant alteration in the Commissioner's approach to the tax treatment of the transferor-annuitant. It provided that the transferor must recognize capital gain pro-rata over his life expectancy from the time of transfer,<sup>19</sup> rather than first allow a

11. Under the Internal Revenue Code of 1939, the ordinary income or interest element was "equal to 3 per centum of the aggregate premiums or consideration paid for such annuity . . ." INT. REV. CODE OF 1939, § 22(b)(2)(A). The aggregate premiums or consideration paid was the equivalent of the fair market value of the property on the date of exchange. Jane J. de Canizares, 32 T.C. 345 (1959), *acquiesced in*, 1959-2 CUM. BULL. 4.

12. REV. RUL. 239, 1953-2 CUM. BULL. 53 [hereinafter referred to as Revenue Ruling 239].

13. *Id.*

14. *Id.*

15. Note, *Private Annuities: Revenue Ruling 69-74—Its Significance, Effect, and Validity*, 23 VAND. L. REV. 675, 676-77 n.11 (1970).

16. *Hill's Estate v. Maloney*, 58 F. Supp. 164 (D.N.J. 1944).

17. The ordinary income or interest element of the payments received under § 72 (formerly § 22 of the 1939 Code) was changed to the excess of the "amount received . . . which bears the same ratio to such amount as the investment in the contract . . . bears to the expected return under the contract . . ." INT. REV. CODE OF 1954, § 72(b).

18. Since the investment in the contract is used as the numerator of the exclusion ratio (the formula used to determine the tax-free portion of payments received) a greater numerator results from the inclusion of unrealized capital gain and therefore more tax-free income. For a more detailed discussion of this point, see Note, *Private Annuities: Revenue Ruling 69-74—Its Significance, Effect, and Validity*, 23 VAND. L. REV. 675, 683-86 (1970).

19. See note 1 *supra*.

tax-free recovery of investment. In effect, the transfer of appreciated property was treated as a "closed" transaction.<sup>20</sup>

Revenue Ruling 69-74 also provided that the "consideration paid" for determining the investment in the contract was the transferor's basis in the transferred property,<sup>21</sup> rather than its fair market value. "Since the amount of the gain is not taxed in full at the time of the transaction, such amount does not represent a part of the 'premiums or other consideration paid' for the annuity contract."<sup>22</sup> This use of basis resulted in a lower exclusion ratio and a corresponding increase in the ordinary income portion of payments received. Further, the use of basis rather than fair market value is in derogation of both prior case law<sup>23</sup> and Revenue Ruling 239, and has been criticized because the gain even after tax is not included in the exclusion ratio computation.<sup>24</sup>

Possibly aware of the weaknesses of Revenue Ruling 69-74, the court in the present case stated that it does not apply to *secured* private annuities. The court held that the investment in the contract (as determined by aggregate consideration paid) used in computing the exclusion ratio of a *secured* private annuity is the fair market value of the property transferred. As its basis for this determination, the court relied on *unsecured* private annuity cases<sup>25</sup> (transactions within the scope of Revenue Ruling 69-74). Although these cases were decided under section 22(b)(2) of the 1939 code, the court indicated that "[n]othing in the statute, the legislative history, or the regulations interpreting section 72 indicates that 'consideration paid' "<sup>26</sup> should be other than the fair market value of the transferred property. In effect, the court may have overruled that part of Revenue Ruling 69-74 which provides that "consideration paid" is the annuitant's basis in the transferred property.<sup>27</sup>

The adoption of fair market value does not, however, resolve the problem raised by the Commissioner in Revenue Ruling 69-74, that the annuitant is receiving the benefit of the unrecognized gain in his exclusion ratio computation. Under the open-transaction approach, a transferor-annuitant would not recoup his basis until his life expectancy was

20. Weinberg, *The New Case for Private Annuities*, 51 NEB. L. REV. 9, 18 (1971). See Note, *Private Annuities: Revenue Ruling 69-74—Its Significance, Effect, and Validity*, 23 VAND. L. REV. 675 (1970).

21. See note 1 *supra*.

22. Rev. Rul. 69-74, 1969-1 CUM. BULL. 43, 44.

23. See cases cited at note 4 *supra* and notes 25, 26 *infra*.

24. Raiborn & Watkins, *Critical Analysis of Private Annuity Taxation*, 50 TAXES 11 (1972); Weinberg, *The New Case for Private Annuities*, 51 NEB. L. REV. 9 (1971); Note, *Private Annuities: Revenue Ruling 69-74—Its Significance, Effect, and Validity*, 23 VAND. L. REV. 675 (1970).

25. *Hill's Estate v. Maloney*, 58 F. Supp. 164 (D.N.J. 1944); *Jane J. de Canizares*, 32 T.C. 345 (1959); *F.A. Gillespie*, 38 B.T.A. 673 (1938).

26. 60 T.C. at 473.

27. In his dissenting opinion, Judge Simpson also agreed that this aspect of Revenue Ruling 69-74 be overruled. "I agree with the majority that the investment in the contract for purposes of section 72 is, in this case, equal to the actuarial value of the annuity, and, in this respect, I would reject Rev. Rul. 69-74, 1969-1 C.B. 43." 60 T.C. at 478.

reached because the return of capital as computed under the exclusion ratio is received pro-rata by the annuitant over his life expectancy. Thus, a transferor who lived less than or only as long as his estimated life under the agreement could effect a tax-free transfer without recognizing any capital gain and yet receive annuity payments, the tax-free portion of which reflected that gain. This may be the reason the court in the present case appears to have attached new conditions to the use of fair market value; namely that the entire capital gain must be immediately recognized upon the transfer of the appreciated property.

Although the court stated that the facts in the present case involve a *secured*, as opposed to an *unsecured* private annuity, it does not appear to have limited its opinion to these facts. Rather it stated:

It would be manifestly inconsistent to find that the annuity contract had a fair market value for purposes of determining a taxpayer's cost or investment in the contract under section 72(c), and yet to hold it had no determinable value for purposes of section 1001 [to determine gain or loss on the transfer].<sup>28</sup>

This implies that even where the promise of the transferee-obligor is *unsecured*, the transferor-annuitant will not only realize capital gain immediately on the transfer but also have to recognize it. Since the major benefit of a private annuity is to effect a tax-free transfer of property (usually to children or relatives) and postpone recognition of capital gain on the transfer,<sup>29</sup> a tax at the outset would put an end to the private annuity as a useful estate planning device.<sup>30</sup>

Furthermore, the immediate recognition of capital gain would extend the closed transaction approach of Revenue Ruling 69-74 beyond the intent of the 1954 Internal Revenue Code. Section 72 of the 1954 Code was enacted because the old 3-percent rule under the 1939 Code did not guarantee the annuitant a fixed amount of taxable income upon which he could rely.

The annuitant finds that after being retired for a few years and becoming accustomed to living on a certain amount of income after tax, he suddenly has to make a sizable downward adjustment in his living standard because, when his exclusion is used up, the annuity income becomes fully taxable.<sup>31</sup>

In fact, Congress, in 1954, specifically rejected a proposal<sup>32</sup> to tax the gain realized on the transfer of property for a private

---

28. 60 T.C. at 476.

29. Ekman, *Utility of Private Annuities in Estate Planning*, N.Y.U. 27TH ANN. INST. ON FED. TAX. 421, 422-23 (1968).

30. Raiborn & Watkins, *Critical Analysis of Private Annuity Taxation*, 50 TAXES 11 (1972).

31. S. REP. NO. 1622, 83d Cong., 2d Sess. 11 (1954).

32. H.R. REP. NO. 1377, 83d Cong., 2d Sess. 84-85 (1954).

annuity in the year of exchange.<sup>33</sup> Thus, an immediate capital gain tax to a transferor, who has not realized the cash with which to pay a tax, has the same forbidden lack of consistency which Congress sought to avoid.

It could be argued that an immediate recognition of capital gain at the outset would eliminate the dispute of whether basis, as contended by the Commissioner in Revenue Ruling 69-74, or the fair market value of the transferred property, as in the present case, is the measure of "premiums or other consideration paid," since both values would be the same after recognition of gain. However, such recognition and taxation directly contradicts the open-transaction approach discussed in *Burnett v. Logan*<sup>34</sup> and the cases following it.<sup>35</sup> The immediate recognition of gain also leaves unresolved: (1) the fact that the ability of the obligor to make payments as due is uncertain and;<sup>36</sup> (2) that the life-span of the annuitant will most probably vary from that predicted, causing the payment of more or less than the expected return.<sup>37</sup> It should also be noted that the court in *J. Darsie Lloyd* stated that although it is permissible to determine value for one tax purpose (fair market value for exclusion computation), it may not necessarily follow for another (recognition of capital gain on the "amount realized").<sup>38</sup>

It appears that a compromise approach is in order, and this writer would adopt the formula presented in Judge Simpson's dissent for both *secured* and *unsecured* private annuities. He suggests:

- (1) Figure the exclusion ratio, using the fair market value of the property transferred to arrive at the tax-free and taxable portion of the annuity payments.
- (2) Recognize capital gain pro-rata over the expected life of the transferor-annuitant out of the tax-free portion of the payments received.
- (3) The remainder is tax-free income.

This approach is consistent with § 72 and eliminates some of the difficulties discussed above.

JEFFREY S. TANEN

---

33. S. REP. No. 1622, 83d Cong., 2d Sess. 116 (1954).

34. 283 U.S. 404 (1931).

35. See *Commissioner v. Kann's Estate*, 174 F.2d 357 (3d Cir. 1949); *Hill's Estate v. Maloney*, 58 F. Supp. 164 (D.N.J. 1944); *J. Darsie Lloyd*, 33 B.T.A. 903 (1942).

36. See note 6 *supra* and accompanying text.

37. *Id.*

38. *J. Darsie Lloyd*, 33 B.T.A. 903 (1942), *acquiesced in*, 1950-2 CUM. BULL. 3.