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NOTES

Private Annuities: Revenue Ruling 69-74—Its Significance, Effect, and Validity

I. BACKGROUND

The private or noncommercial annuity may be defined as the transfer of property from an annuitant-transferor to a person or organization (referred to as the transferee or obligor) that has not "from time to time"[1] issued annuity contracts, in exchange for the transferee's unsecured promise to make periodic payments of money for a fixed time or for the life of the annuitant-transferor.[2] Prior to the issuance of Revenue Ruling 69-74,[3] both the Internal Revenue Service and the courts had given the private annuity transaction favorable income tax treatment,[4] making it an extremely useful estate planning

1. *See* Rev. Rul. 62-136, 1962-2 CUM. BULL. 12, discussed in notes 82-83 *infra* and accompanying text.

2. *See* Ekman, *Utility of Private Annuities in Estate Planning*, N.Y.U. 27TH INST. ON FED. TAX. 421, 422 (1969); Middleditch, *Mechanics of the Private Annuity as an Estate Planning Device*, 15TH ANN. TUL. TAX INST. 469, 469-70 (1965); Wallace, *Taxation of Private Annuities*, 40 B.U.L. REV. 349, 349-50 (1960). An example of a typical private annuity transaction between a father and his closely-held corporation is set out in McGiveran & Lynch, *Private Annuities*, 13 J. AM. SOC'Y C.L.U. 14, 14-15 (1958).

3. 1969-1 CUM. BULL. 43.

4. The gift and estate tax consequences of the private annuity arrangement can also be quite favorable. There is no taxable gift if (1) the fair market value of the property transferred equals the actuarial value of the annuity, and (2) the purchase price is the result of arms-length bargaining; that is, there is no donative intent. This second requirement is generally a problem where the transaction involves closely-related parties. *See* Estate of Koert Bartman, 10 T.C. 1073 (1948); Estate of Sarah A. Bergan, 1 T.C. 543 (1943).

With respect to the estate tax, the transfer effectively removes the property from the gross estate of the transferor, except to the extent that the gift element could be considered a gift in contemplation of death. The annuitant can, however, at the time of the transfer create evidence that it was not in contemplation of death. *E.g.*, Des Portes v. United States, 171 F. Supp. 598, 601 (E.D.S.C. 1959) (fact that annuitant made transfer without legal advice demonstrated that he was not concerned with disposing of his property in contemplation of death); Estate of Hilda M. Lenna, 19 CCH Tax Ct. Mem. 803, 806 (1960) (evidence that stock was transferred in order to maintain family control of a closely-held corporation demonstrated that it was not a transfer in contemplation of death). Moreover, in certain instances, courts have deemed the annuitant to have retained a life estate in the property transferred: First, where the annuity payments are measured and paid out of the income derived from the property (Updike v. Commissioner, 88 F.2d 807, 813 (8th Cir. 1937); Estate of Cornelia B. Schwartz, 9 T.C. 229, 237-38 (1947); Rev. Rul. 55-378, 1955-1 CUM. BULL. 447)); second, where the use or resale of the property or its proceeds is restricted (Greene v. United States, 237 F.2d 848, 852-53 (7th Cir. 1956)); third, where the annuity transaction is secured (Tips v. Bass, 21 F.2d 460, 462 (W.D. Tex. 1927); Estate of Cornelia B. Schwartz, *supra* at 237)).

device. In *J. Darsie Lloyd*,[5] the Board of Tax Appeals applied the principle of *Burnet v. Logan*[6] to a private annuity and held that an annuitant-father realizes no immediate gain when he transfers appreciated stock to his son, in exchange for the son's promise to pay his father a life annuity. Dealing with the question of when the annuitant will be required to report his gain, the court in *Hill's Estate v. Maloney*[7] concluded that (1) the gain should commence to be taxed when the total payments received under the annuity contract equal the cost basis of the property transferred, and (2) the entire amount of each payment thereafter received should be taxed as capital gain until the total payments received under the contract equal the fair market value of the property at the time of the transfer. In its only ruling regarding the income tax consequences of private annuity transactions issued prior to Revenue Ruling 69-74, the Service adopted the two basic conclusions of the court in *Hill's Estate*.[8] The only modification made by the IRS was its ruling that the payments received by the annuitant, which are first applied in reduction of his basis and then as gain from the sale of the property, must be reduced for amounts taxed under the annuity rules.[9] Once the full amount of gain has been taxed, the majority and better view would treat the "excluded portion"[10] of any excess payments as tax-free to the annuitant.[11]

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5. 33 B.T.A. 903 (1936), *nonacquiesced in*, XV-2 CUM. BULL. 39 (1936), *nonacquiescence withdrawn and acquiesced in*, 1950-2 CUM. BULL. 3. In the Board's opinion, the son's promise to pay his father a life annuity had no ascertainable fair market value because of "the uncertainty as to whether or not the one agreeing to make payments will be able to make them as agreed when the time for payment actually arrives." 33 B.T.A. at 905. The *Lloyd* holding has been followed consistently by the courts. *E.g.*, Commissioner v. Kann's Estate, 174 F.2d 357 (3d Cir. 1949); Evans v. Rothensies, 114 F.2d 958 (3d Cir. 1940); Hill's Estate 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).

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

7. 58 F. Supp. 164 (D.N.J. 1944).

8. Rev. Rul. 239, 1953-2 CUM. BULL. 53. The IRS specifically adopted the holding in *J. Darsie Lloyd* and *Commissioner v. Kann's Estate. Id.* at 54.

9. Only the "excluded portion" of each annuity payment will be considered as a recovery of basis; and only such "excluded portion," after basis is fully recouped, will be taxed as gain realized from the sale of property. The Internal Revenue Code of 1939 treated the "excluded portion" as "the excess of the amount received in the taxable year over an amount equal to 3 per centum of the aggregate premiums or consideration paid [note 16 *infra*] for such annuity . . . ." INT. REV. CODE of 1939, § 22(b)(2)(A). The 3% of "the aggregate premiums or consideration paid" represents the interest element and is taxable at ordinary rates. Under the 1954 Code, the "excluded portion" is computed by dividing the cost of the annuity ("the aggregate premiums or consideration paid [note 16 *infra*] for such annuity") by the annuitant's remaining life expectancy and multiplying the resulting fraction by the amount of the total payments received in the taxable year. INT. REV. CODE of 1954, § 72(b). The remainder of each payment represents the interest element, taxable as ordinary income.

10. The "excluded portion" equals the total amount of the annuity payment less the interest element. *See* note 9 *supra*.

11. The 1939 Code provided that annuity payments in excess of 3% of the consideration

In Revenue Ruling 69-74, the advice of the IRS was requested as to the tax treatment, for federal income and gift tax purposes, of a transfer of monthly payments received under the following circumstances. The taxpayer, age 74, transferred to his son a capital asset, having an adjusted basis of 20,000 dollars and a fair market value of 60,000 dollars, in exchange for the son's promise to pay the taxpayer a life annuity of 7,200 dollars per year in equal monthly installments of 600 dollars. On these facts, the Service ruled as follows:

(1) The annuitant realizes capital gain[12] immediately, but it will be payable over his remaining life expectancy.[13]

(2) In computing the "exclusion ratio,"[14] the annuitant's

paid for the annuity were to be excluded from gross income only "until the aggregate amount excluded from gross income . . . equals the aggregate premiums or consideration paid [note 16 *infra*] for such annuity." INT. REV. CODE of 1939, § 22(b)(2)(A). When payments totaling the fair market value of the transferred property were received by the annuitant, all payments received thereafter were to be included in gross income. Hill's Estate v. Maloney, 58 F. Supp. 164, 174 (D.N.J. 1944); Rev. Rul. 239, 1953-2 CUM. BULL. 53. Unlike the 1939 Code, the 1954 Code contains no limitation on how long the annuity rules apply to the payments received by the annuitant. Furthermore, prior to Rev. Rul. 69-74, there were no decisions or rulings under the 1954 Code which answered the question of the proper income tax treatment of payments received after gain from the sale of the property was fully reported. While it has been suggested that the "excluded portion" of each payment may continue to be taxed as gain from the sale of property (*e.g.*, Ross, *The Private Annuity as a Tax Minimizing Instrument*, 41 TAXES 199, 207 (1963)), the overwhelming majority of the commentators adopt the view that the balance of each payment should be treated as nontaxable excess capital return. *E.g.*, 1 J.K. LASSER, ESTATE TAX TECHNIQUES 766 (1969); Cohen, *Recent Developments in the Taxation of Private Annuities*, U. So. CAL. 1964 TAX INST. 491, 496; Ekman, *supra* note 2, at 428; Farmer, *Private Annuities: Their Tax Consequences From Buyer's and Seller's Viewpoints*, 101 TRUSTS & Es. 28, 29 (1962); Goldberg, *Annuities, A Comparative Analysis: Intra-Family, College-Type, Commercial*, N.Y.U. 22ND INST. ON FED. TAX 1213, 1229 (1964); Wallace, *supra* note 2, at 358. The majority's method has considerable merit in that it taxes the annuitant on excess payments received in the same manner as an annuitant who transfers an equivalent value in cash rather than property. S. REP. No. 1622, 83d Cong., 2d Sess. 11 (1954), *reprinted in* 3 U.S. CODE CONG. & AD. NEWS 4641 (1954). The courts have consistently held that it makes no difference whether the consideration paid for the annuity is property or cash. Cases cited note 58 *infra*.

12. According to U.S. Life Table 38 (see notes 19-20 *supra* and accompanying text), the present value of the taxpayer-father's annuity contract is $47,713.08. The difference between this amount and the father's adjusted basis for the capital asset transferred ($20,000) is capital gain.

13. "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 includible in gross income by virtue of the application of section 72 of the 1954 Code." Rev. Rul. 69-74, 1969-1 CUM. BULL. 43, 43-44.

14. The "exclusion ratio" is defined in INT. REV. CODE of 1954, § 72(b): "Gross income does not include that part of any amount received as an annuity under an annuity . . . contract which bears the same ratio to such amount as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date)." Section 72(c)(1)(A) defines the "investment in the contract" as "the aggregate amount of premiums or other consideration paid for the contract." The "expected return" equals the annual proceeds multiplied by the annuitant's life expectancy which, according to § 72(c)(3)(A), "shall be

"investment in the contract," applied only to determine his recovery of his capital investment,[15] is not the fair market value of the consideration furnished for the annuity but rather the annuitant's adjusted basis for the consideration furnished.[16]

(3) There is no increase in the annuitant's basis for the capital gains tax paid each year. The annuitant's "investment in the contract" continues to be his basis for the consideration paid for the annuity even though he is currently paying taxes on the capital gain that is said to be realized.[17]

(4) If the annuitant outlives his life expectancy, his "investment in the contract" continues to be his basis even though he has paid a tax and incurred a cost.[18]

(5) U.S. Life Table 38[19] is to be used in determining the present value of a private annuity contract.[20]

(6) Revenue Ruling 239,[21] having been issued under the 1939

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computed with reference to actuarial tables prescribed by the Secretary or his delegate." In the instant ruling, the Service apparently relied on Table IV in Treas. Reg. § 1.72-9 (1957). Applying these annuity rules to the facts in Rev. Rul. 69-74, the IRS arrived at the following figures. The expected return under the contract is 10.1 x $7,200 or $72,720. The investment in the contract is $20,000 (the father's adjusted basis for the transferred property; *see* note 16 *infra*), and that amount divided by $72,720 (the expected return) produces an exclusion ratio of 27.5%.

15. Prior to Rev. Rul. 69-74, the higher exclusion ratio (*see* note 16 *infra*) was first applied to recoup the annuitant's basis for the transferred property. After full recovery of the basis, the exclusion ratio portion of each payment was taxed as gain from the sale of the property until the gain realized was fully reported.

16. Under § 22(b)(2)(A) of the 1939 Code, the "aggregate premiums or consideration paid" for a private annuity (the equivalent of the "investment in the contract" under § 72(c)(1)(A) of the 1954 Code) was the fair market value of the property on the date of exchange. Jane J. de Canizares, 32 T.C. 345, 352-53 (1959), *acquiesced in*, 1959-2 CUM. BULL. 4; Rev. Rul. 239, 1953-2 CUM. BULL. 53. Although there are no cases concerning the determination of the "investment in the contract" under the 1954 Code, it had been assumed, prior to the issuance of Rev. Rul. 69-74, that the fair market value rule stated in the *de Canizares* case applied equally under § 72. *See, e.g.*, ABA COMM. ON ESTATE AND TAX PLANNING, *Report of Subcommittee on Private Annuities and Estate Planning*, 102 TRUSTS & ES. 952, 954 (1963); Cohen, *supra* note 11, at 494-95. The reason given by the IRS for its change of position was as follows: "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." Rev. Rul. 69-74, 1969-1 CUM. BULL. 43, 44.

17. "The exclusion ratio of 27.5 percent [determined by dividing $20,000 (the annuitant's basis for the property transferred) by $72,720 (the expected return)] is applicable throughout the life of the contract." Rev. Rul. 69-74, 1969-1 CUM. BULL. 43, 44.

18. *See* note 17 *supra*.

19. U.S. Life Table 38 is contained in Treas. Reg. § 20.2031-7(f) (date of Table is 1939-41).

20. The IRS ruled that Treas. Reg. § 1.101-2(e)(1)(iii)(b)(3) (1957) prescribes the use of U.S. Life Table 38 for valuing a private annuity contract.

21. 1953-2 CUM. BULL. 53. See text accompanying notes 7-8 *supra*.

Code, is not determinative under section 72(b) of the 1954 Internal Revenue Code.

II. SIGNIFICANCE AND EFFECT OF REVENUE RULING 69-74

A. Valuation of Annuity Contract

A basic problem in all private annuity transactions is the assignment of a proper value to the annuitant's contractual right to receive life payments from the obligor. There are three methods which have been used to determine the value of an annuity contract: (1) by utilizing U.S. Life Table 38 contained in Treasury Regulation § 20.2031-7(f); (2) by deriving the value of a comparable commercial annuity; (3) by employing an actuary who would derive the value from an examination of the particular facts of the transaction.

The use of U.S. Life Table 38 to value private annuity contracts, the method of valuation adopted in Revenue Ruling 69-74, has recently been approved by the Fourth Circuit Court of Appeals in *Dix v. Commissioner*.[22] The Fourth Circuit upheld the reasonableness of U.S. Life Table 38, however, as against only two methods of attack. First, the annuitant argued that the appropriate table in Treasury Regulation section 1.72-9 should be used to determine the present value of the annuity contract.[23] Second, the annuitant argued in the alternative that the annuity contract should be valued according to what a commercial life insurance company would have charged for a comparable contract. The court's answer to the taxpayer's first contention was that "Treas. Reg. § 1.72-9, Table 1 is a table of life expectancies of persons who have purchased annuity contracts *from commercial insurance companies*."[24] Similarly, the court disposed of the taxpayer's second contention by holding that rates charged by commercial life insurance companies are affected by several factors, not present in private annuity transactions, which operate to increase the cost of commercial annuity contracts above the cost of private annuity contracts with comparable payments. In reaching this conclusion, the court relied solely upon the

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22. 392 F.2d 313 (4th Cir. 1968), *aff'g* 46 T.C. 796 (1966).

23. The tables in Treas. Reg. § 1.72-9 (1957) list remaining life expectancies ("expected return multiples") according to age and sex. After obtaining this figure, the taxpayer argued, the Commissioner should then obtain the proper multiple (to be multiplied times the annual annuity payment to produce the annuity contract's present value) by referring to any available table which lists such multiples according to the annuitant's remaining life expectancy and an assumed rate of interest. In his brief, the taxpayer-annuitant used Table 7 (Present Value of Annuity of 1 at End of Each Period) in ACCOUNTANTS' HANDBOOK 1444-45 (W.A. Paton ed. 1947).

24. 392 F.2d at 317 (emphasis added).

testimony of one expert witness, an actuary with the IRS, who listed the "several factors" as follows:[25] (1) Commercial life insurance companies are regulated by state law which restricts their investments and requires them to maintain sufficient reserves to assure that annuity payments can be made. (2) Insurance company annuity prices contain a margin for anticipated expenses and profits. (3) Insurance companies base their prices for annuity contracts on mortality tables reflecting longer than average life expectancies over which payments must be made.[26] Obviously, the *Dix* court's holding that Treasury Regulation section 20.2031-7(f) (prescribing the use of U.S. Life Table 38 to value private annuity contracts) is valid is limited to its reasonableness as compared with tables used by commercial life insurance companies. The taxpayer in *Dix* posed no alternative method of valuation against which the court could judge the regulation's validity. While the cost of a comparable commercial annuity should, perhaps, not be used to value a private annuity, it does not necessarily follow that the use of U.S. Life Table 38 is reasonable. U.S. Life Table 38 is subject to several serious infirmities. First, it makes no distinction between males and females, as do all commercial annuity tables.[27] Second, many experts feel that the Commissioner's tables contained in Treasury Regulation section 20.2031-7(f) are actuarially unsound since they are based on life expectancy as it existed more than 30 years ago.[28] Third, the Commissioner's tables fail to take into account the annuitant's state of health.[29] In Revenue Ruling 69-74, the only justification given for the use of U.S. Life Table 38 is that "[s]ection 1.101-2(e)(iii)(b)(3) of the regulations prescribes the appropriate table to be used for valuing a private annuity contract."[30] The flaw in this reasoning is that

25. Brief for Respondent at 21, 34-35, Dix v. Commissioner, 392 F.2d 313 (4th Cir. 1968).

26. According to the witness's testimony, such mortality tables are used because actuarial experience has shown that on the average annuitants live longer than the general population since one does not ordinarily buy an annuity unless he knows he is in good health. *Id.* at 35.

27. Brief for Petitioners at 24a-25a, Dix v. Commissioner, 392 F.2d 313 (4th Cir. 1968). Under the 1937 Standard Insurance Annuity Table and the tables in Treas. Reg. § 1.72-9, females have a 5 year longer life expectancy than males.

28. Cohen, *supra* note 11, at 505; Ekman, *supra* note 2, at 423. The courts, however, have generally been reluctant to disallow the use of obviously out-of-date annuity tables to determine the value of private annuities. *See, e.g.*, McMurtry v. Commissioner, 203 F.2d 659 (1st Cir. 1953); Koshland's Estate v. Commissioner, 177 F.2d 851 (9th Cir. 1949).

29. It should be noted, however, that where the physical condition of an annuitant is so hopeless that normal life expectancy is drastically shortened, the courts have abandoned the Commissioner's actuarial tables and have held that valuation may be made by reference to actual, rather than statistical, life expectancy. *E.g.*, Estate of John P. Hoelzel, 28 T.C. 384, 389 (1957), *acquiesced in*, 1957-2 CUM. BULL. 5; Estate of N.M. Butler, 18 T.C. 914, 919-20 (1952); Huntington Nat'l Bank, 13 T.C. 760, 770 (1949); Estate of Nellie H. Jennings, 10 T.C. 323, 327-28 (1948); Estate of J.H. Denbigh, 7 T.C. 387, 389 (1946).

30. 1969-1 CUM. BULL. 43.

Treasury Regulation section 1.101-2(e)(1) applies only "where *death benefits* are paid in the form of annuity payments."[31]

Taxpayers' efforts to persuade courts to base the valuation of a private annuity contract on the cost of a comparable commercial annuity have sometimes been successful.[32] More recently, the IRS has ruled that annuity contracts issued by organizations that "from time to time" enter into agreements to pay life annuities "are sufficiently comparable to individual annuity contracts issued by commercial insurance companies to justify the application of a similar standard of valuation to both."[33] The Fourth Circuit in *Dix* refused to extend this ruling to an annuity issued by a private individual.[34] Nevertheless, there is something to be said for using the cost of a comparable commercial annuity to value a private annuity. The basic advantage this method of valuation has over the use of U.S. Life Table 38 is that tables used by commercial insurance companies are up-to-date.[35] Thus, the multiples contained in these tables will reflect today's longer life expectancies. Mortality tables used by commercial insurance companies also have different sets of figures for males and females, since females on the average tend to live five years longer than males.[36] Moreover, commercial insurance companies vary their assumed rate of interest[37] according to fluctuations in the economy. U.S. Life Table 38, on the other hand, establishes an arbitrary rate of return of three and one-half percent. The pitfalls involved in using the cost of a comparable commercial annuity to value a private annuity have already been pointed out. Like U.S. Life Table 38, commercial mortality tables fail to take into consideration the annuitant's state of health.[38] Furthermore, at least according to one expert and one United States court of appeals, several factors peculiar to the life insurance industry

31. Treas. Reg. § 1.101(2)(e)(1) (1957) (emphasis added).

32. *E.g.*, Maud Gillespie, 43 B.T.A. 399, 405-06 (1941), *acquiesced in*, 1941-1 CUM. BULL. 5; Anna L. Raymond, 40 B.T.A. 244, 249 (1939), *acquiesced in*, 1939-2 CUM. BULL. 31, *aff'd*, 114 F.2d 140, 143 (7th Cir. 1940), *cert. denied*, 311 U.S. 710 (1940).

33. Rev. Rul. 62-137, 1962-2 CUM. BULL. 28.

34. "It will be noted that, by its terms, this ruling [Rev. Rul. 62-137] applies only to organizations which enter into annuity contracts 'from time to time.' We believe that it was intended to embrace only those organizations which write enough annuity contracts to obtain a good spread of the actuarial risk." 392 F.2d 313, 316 (4th Cir. 1968).

35. U.S. Life Table 38 was computed in the period from 1939 to 1941. Treas. Reg. § 20.2031-7(e).

36. Note 27 *supra*.

37. The assumed rate of interest on the unpaid principal (sometimes called the discount rate) is one of 3 elements involved in actuarially computing the value of an annuity. The other 2 elements are the amount of each periodic payment and the life expectancy of the annuitant.

38. *But see* note 29 *supra*.

make it unrealistic to determine the value of a private annuity by deriving the value of a comparable commercial annuity.[39]

Since both U.S. Life Table 38 and commercial annuity tables are unsatisfactory means by which to value private annuity contracts, it is submitted that the best method of valuation would be to allow the annuitant to make his own estimate of the annuity contract's worth.[40] He could initially undergo a thorough physical examination in order to determine whether it is proper to apply a life expectancy table in his particular case.[41] Then the annuitant could hire an independent actuary who would apply the current interest rate to a modern life expectancy table if the annuitant's state of health is satisfactory and, if not, to an estimated life expectancy figure agreed upon by at least two competent physicians who have examined the annuitant. The parties should be certain to specify in their contract the actuarial foundations upon which the annuity's value is based.[42]

In view of the justified criticism that has been levied against Treasury Regulation section 20.2031-7(f)[43] and the relative merit in allowing the annuitant to make his own estimate of the annuity's worth, it seems that the regulation should be held invalid as a means of valuing private annuity contracts.[44] Whether or not the

39. Text accompanying notes 25-26 *supra.*

40. Several income tax cases have permitted the taxpayer to make his own determination of the value of the annuity. In Commissioner v. John C. Moore Corp., 42 F.2d 186, 188 (2d Cir. 1930), the court held that "[t]he parties were free to ignore the mortality tables and to make their own estimate; in view of Mrs. Moore's [the annuitant's] condition of health at the time, they were justified in basing their calculations on a life probability of not more than eleven years. [Mrs. Moore had a remaining life expectancy, according to mortality tables, of 17.4 years, but she was in very poor health.] That subsequent events showed her to be much hardier than either party suspected cannot affect the contract made [earlier]." *See also* Gladys Chessman Evans, 30 T.C. 798, 803-04 (1958) (annuitant's financial advisers based their valuation upon a commercial annuity applied to the particular facts of her case).

41. *See* text accompanying note 38 *supra.*

42. One writer is of the opinion that the Commissioner's success in persuading the courts to accept his tables against various forms of challenge is due largely to the failure of the contracting parties to specify in their contract the actuarial foundations upon which the annuity's value is based. Wallace, *supra* note 2, at 372. Another writer also suggests that if all the factors of the annuity are negotiated at arms length, no gift tax should be imposed even if the Commissioner attacks the annuitant for using his own actuarial valuation instead of the tables in Treas. Reg. § 20.2031-7(f). Cohen, *supra* note 11, at 515.

43. Text accompanying notes 27-29 *supra.* Treas. Reg. § 20.2031-7(f) contains U.S. Life Table 38.

44. The Fourth Circuit's holding in Dix v. Commissioner, 392 F.2d 313 (4th Cir. 1968), limited to its facts, sustains the validity of Treas. Reg. § 20.2031-7(f) only as against 2 alternative modes of attack: first, that the Commissioner's annuity tables contained in Treas. Reg. § 1.72-9 should be used to value private annuity contracts, and second, that private annuity contracts should be valued according to the cost of a comparable commercial annuity. The

Commissioner will be allowed to continue to use the tables in Treasury Regulation section 20.2031-7(f) to value private annuities is of critical importance to the annuitant in terms of tax consequences. First, the annuitant's gift tax liability, if any, is measured as the excess of the value of the property transferred over the value of the annuity. Using U.S. Life Table 38, based on low life expectancies, produces a low multiple and thus a low annuity value, thereby increasing the amount of the gift from the annuitant to the obligor.[45] Second, prior to Revenue Ruling 69-74, the "investment in the contract" was generally thought to be the fair market value of the property transferred;[46] but where the transaction contained a gift element, the "investment in the contract" could only be determined by the value of the annuity contract.[47] This lower "investment in the contract" decreased the exclusion ratio and thereby increased the interest element.[48]

B. Sale-Purchase Theory

The property transferred by the annuitant is usually not cash but some other type of property interest such as corporate stock.[49] For this reason, the acquisition of an annuity for property must be viewed as either (1) two transactions, a sale of the property and a simultaneous purchase of the annuity with the proceeds therefrom, or (2) one transaction only, the purchase of an annuity in exchange for the

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taxpayer failed to raise, and the court in *Dix* did not mention, whether Treas. Reg. § 20.2031-7(f) would be deemed valid when compared with the valuation method of allowing the parties to assess the annuity themselves.

45. *Compare* U.S. Life Table 38 (designated as Table 1) in Treas. Reg. § 20.2031-7(f) *with* the more modern mortality table in Rev. Rul. 62-137, 1962-2 CUM. BULL. 28. If the IRS had used the table in Rev. Rul. 62-137, instead of U.S. Life Table 38, to value the annuity in Rev. Rul. 69-74, the annuity's value would have been (8.043 + .482) x $7,200 = $61,380. Thus, since the value of the property was $60,000, there would have been no gift from the annuitant to the obligor.

46. Note 16 *supra* and accompanying text.

47. In other words, the annuitant's "investment in the contract" (the fair market value of the property transferred) had to be decreased by the amount of the gift. *E.g.*, Edmund A. Steenburg, 10 P-H B.T.A. Mem. Dec. ¶ 41,184, at 374, 375 (1941).

48. The end result is that the annuitant's income, taxable at ordinary rates, is increased. *See* note 9 *supra*.

49. Anything can be transferred for an annuity: homes, rental units, vacant lots, sailboats, merchant steamers, machinery, oil wells, jewelry, automobiles, furniture, and stamp collections. Nor need the annuitant transfer his entire interest in the property transferred. For example, a farmer may transfer an acreage from his farm, or a doctor may transfer an interest in his clinic building. One may transfer partnership interests, interests in trusts and estates, and various types of claims and choses in action. The ability of the obligor to pay should be considered in deciding what type of property to transfer. If the transferee-obligor has substantial independent income, almost anything can serve, but if he has only limited income, the property transferred should be of a type which the obligor can resell or borrow against.

transfer of property. The first view, commonly referred to as the "Sale-Purchase Theory," had been consistently applied by both the courts and the Commissioner prior to Revenue Ruling 69-74.[50] Since presumably the supposed sale of the property yields proceeds equal to its fair market value, the "Sale-Purchase Theory" explains why the fair market value of the property at the date of the transfer was used as the cost of the annuity (referred to as the "investment in the contract" by the 1954 Code).[51] Under the second view, which is adopted by the IRS in Revenue Ruling 69-74,[52] the "investment in the contract" is the annuitant's adjusted basis for the property transferred.

The Service's solution to the natural consequence of its abandonment of the "Sale-Purchase Theory" defies logic. The annuitant's "investment in the contract" is the numerator of the exclusion ratio fraction under section 72; the use of a lower figure as the numerator produces a lower exclusion ratio and, therefore, more ordinary income. Using the annuitant's basis for the property rather than its fair market value as his "investment in the contract" also means that only the basis can be recouped out of the excluded portion during the annuitant's remaining life expectancy. Thus, the annuitant must receive his capital gain[53] out of the nonexcluded portion of each payment.[54] Accordingly, Revenue Ruling 69-74 provides that each annuity payment is part capital gain and part ordinary income.[55] This unusual income tax treatment of the private annuity transaction is not

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50. *See, e.g.*, Hill's Estate v. Maloney, 58 F. Supp. 164 (D.N.J. 1944); Jane J. de Canizares, 32 T.C. 345 (1959), *acquiesced in*, 1959-2 CUM. BULL. 4; John C. Moore Corp., 15 B.T.A. 1140, 1144 (1929), *aff'd*, 42 F.2d 186 (2d Cir. 1930); Rev. Rul. 239, 1953-2 CUM. BULL. 53. *See* note 16 *supra*.

51. *See* cases cited note 50 *supra*.

52. The IRS appears to be adopting the position of the court in Ware v. Commissioner, 159 F.2d 542 (5th Cir. 1947), which is the only court decision standing for this view. However, the court in *Ware* held that all annuity payments received which were not attributable to the adjusted basis would be taxed as ordinary income, whereas the IRS in Rev. Rul. 69-74 ruled that capital gain must be reported out of the portion of each annuity payment which would otherwise be ordinary income.

53. This assumes that the property constitutes a capital asset within the meaning of INT. REV. CODE of 1954, § 1221.

54. Prior to Rev. Rul. 69-74, the entire nonexcluded portion of each annuity payment was always thought to be the interest element, taxed as ordinary income. *E.g.*, ABA COMM. ON ESTATE AND TAX PLANNING, *supra* note 16, at 954; Ekman, *Private Annuities*, 22 OHIO ST. L.J. 279, 283 (1961); Fair, McKinster & Zisman, *The Private Annuity*, 40 U. COLO. L. REV. 338, 340 (1968); 1 J.K. LASSER, *supra* note 11, at 763; Middleditch, *supra* note 2, at 478.

55. The IRS requires that the total capital gain be divided by the annuitant's remaining life expectancy and reported ratably over such period. Ordinary income equals total annual payments minus the sum of the excluded portion plus the capital gain. After the capital gain has been fully reported, all subsequent amounts received, after applying the exclusion ratio, are to be treated as ordinary income.

only completely new,[56] but also seems to violate the intention of Congress expressed in section 72 of the 1954 Code that the nonexcluded portion represents interest income, all of which is taxed as ordinary income.[57] Section 72 makes sense only if the numerator of the exclusion ratio fraction is the property's fair market value on the date of exchange and the entire nonexcluded portion of each annuity payment is treated as interest income received in excess of fair market value. Section 72 was written to apply to a transfer of *cash* in exchange for an annuity. In this situation, Congress would be interested in taxing as interest income only the portion of each annuity payment which remains after a fraction equal to the total amount of cash paid for the annuity divided by the annuitant's remaining life expectancy is applied to each payment. In other words, the exclusion ratio would equal the cash paid for the annuity divided by the expected return. It has long been held that it makes no difference whether the consideration paid for the annuity was property rather than money.[58] Therefore, the numerator of the exclusion ratio should be the property's fair market value, since the annuitant would merely have to sell his property to a third party (for its fair market value) and exchange the cash proceeds to the transferee-obligor in order to achieve such a result.

Even if the courts adopt the reasoning underlying the IRS's ruling that the "investment in the contract" is the annuitant's adjusted basis for the property transferred,[59] under this very reasoning the "investment in the contract" must be an amount in excess of basis. The Service stated that "[s]ince 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 [investment in the contract]."[60] According to this reasoning, any part of the gain which is taxed "at the time of the transaction" (in year 1) should be added to basis in determining the annuitant's "investment in the contract."[61] In each year thereafter, the "investment

56. *See* note 54 *supra*.

57. *See* 3 U.S. CODE CONG. & AD. NEWS 4157-58 (1954).

58. *E.g.*, Ware v. Commissioner, 159 F.2d 542 (5th Cir. 1947); Gillespie v. Commissioner, 128 F.2d 140 (9th Cir. 1942); Commissioner v. John C. Moore Corp., 42 F.2d 186 (2d Cir. 1930); Guaranty Trust Co. of New York, 15 B.T.A. 20 (1929); Florence L. Klein, 6 B.T.A. 617 (1927).

59. Prior to Rev. Rul. 69-74, courts and tax scholars had consistently assumed that the "Sale-Purchase Theory" applied to private annuity transactions, rendering an "investment in the contract" equal to the property's fair market value on the date of transfer. Notes 50-51 *supra* and accompanying text.

60. 1969-1 CUM. BULL. 43, 44.

61. Since Rev. Rul. 69-74 requires that capital gain be reported ratably over the annuitant's remaining life expectancy, the gain taxed in year 1 equals the total capital gain ($27,713.08) divided by the remaining life expectancy (10.1 years) or $2,743.87. This figure added to the basis of $20,000 would produce a $22,743.87 "investment in the contract" in year 1.

in the contract" should be increased by the amount of additional gain taxed in that year.[62]

C. Payments Received After Capital Gain is Fully Reported

The next problem that arises is how to tax payments received by the annuitant after he has outlived his life expectancy. Prior to Revenue Ruling 69-74, the long-lived annuitant posed only one problem: How are continuing payments *attributed to the exclusion ratio* to be taxed?[63] The lesser nonexcluded portion, which had constituted the interest element since the first year of the transaction,[64] simply continued as such. Revenue Ruling 69-74, by adopting a much lower exclusion ratio which it rules is to remain fixed even as the gain is taxed, raises an additional problem: What is the excluded portion? Since the capital gain should be added to the annuitant's "investment in the contract" (basis) as he is taxed on it,[65] the excluded portion should equal basis *plus total capital gain*; this sum is then divided by the expected return. The remainder of each payment (the nonexcluded portion), taxed as ordinary income, would remain constant throughout the life of the contract. Under Revenue Ruling 69-74, however, the nonexcluded portion suddenly jumps from 2,476.13 dollars to 5,200.00 dollars per year.[66] This sudden increase in the annuitant's tax bill defeats the express intent of Congress in enacting section 72 of the 1954 Code. The Senate Report on the 1939 Code rule[67] specifically limited the

62. In each year after year 1, $2,743.87 should be added to the previous year's "investment in the contract" figure until the total capital gain plus basis plus the gift element equal the property's fair market value (in the year the annuitant reaches his life expectancy). *See* note 61 *supra*.

63. The majority and better-reasoned view was that the excluded portion of payments received by the annuitant after he had fully recouped his capital gain should be tax-free. *See* notes 11 *supra* and 69 *infra*.

64. Note 54 *supra*.

65. Text accompanying notes 59-62 *supra*.

66. Rev. Rul. 69-74 provides that capital gain is to be reported ratably over the annuitant's life expectancy, but only out of the portion of each payment otherwise taxable as ordinary income. Thus, after the annuitant has fully reported capital gain, the entire nonexcluded portion (72.5% of each annuity payment in Rev. Rul. 69-74) becomes taxable as ordinary income. A quote by M. Paul Andro seems applicable here: "There is no magic potion which transforms payments which are similar in nature and kind from capital gains to ordinary income simply because the annuitant's consideration for the annuity contract has been recovered." Andro, *Non-Commercial Annuities—Income Tax Consequences To The Transferor Who Exchanges Property In Return For An Annuity*, 9 TAX L. REV. 85, 96 (1953).

67. INT. REV. CODE of 1939, § 22(b)(2)(A). For the IRS's application of this section of the 1939 Code to private annuities, see Rev. Rul. 239, 1953-2 CUM. BULL. 53.

application of the exclusion ratio to payments received during the annuitant's life expectancy period:

> This present rule [1939 Code rule] is objectionable because . . . 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.[68]

While Revenue Ruling 69-74 correctly states that the excluded portion maintains its tax-free status even after the annuitant has outlived his life expectancy,[69] this is an illusory break for the annuitant-taxpayer since his total tax bill in these years is increased by one-third.[70]

D. *Is the Exchange a Taxable Event?*

In the landmark case of *Doyle v. Mitchell Brothers Co.*,[71] the Supreme Court established the proposition that when one sells property having a known cost, this cost must be deducted from gross receipts in determining taxable income.[72] *Burnet v. Logan*[73] adopted the position taken in *Doyle* but carried it further by setting the time when a taxpayer would be required to report his gain:

> The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions and speculation. When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like

68. S. REP. No. 1622, 83d Cong., 2d Sess. 11 (1954), *reprinted in* 3 U.S. CODE CONG. & AD. NEWS 4640 (1954).

69. The argument for excluding these payments from income is that they would be excluded on a cash-purchased annuity (Treas. Reg. § 1.72-4(a)(4) (1956)), and the courts hold that it makes no difference whether the consideration paid for the annuity is cash or property. Cases cited note 58 *supra*. *See also* Goldberg, *supra* note 11, at 1231. The theoretical argument for the proposition that the payments retain their tax-free status is that such payments are attributable to the annuity and not the original sale of assets. *Id.* at 1229.

70. This one-third increase assumes that the taxpayer is in a 50% tax bracket. See Table 2 of the Appendix.

71. 247 U.S. 179 (1918).

72. "In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration." *Id.* at 185.

73. 283 U.S. 404 (1931). In *Burnet v. Logan*, the taxpayer owned stock that entitled her to receive a portion of the ore mined by another concern. She sold this stock for cash plus a promise by the buyer to pay 60¢ per ton of ore extracted from the mine. The Commissioner claimed that the obligation of the buyer to make the 60¢ payments had an ascertainable fair market value at the time of the sale, so that the transaction should be considered closed and the recipient taxed on the fair market value of the obligation, plus the cash received, less her basis. The taxpayer-seller claimed that her right to receive the 60¢ payments was impossible to value with fair certainty and that, therefore, none of the payments she received should be taxed until she recovered her basis in the stock.

> fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. . . . She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture.[74]

In holding that none of the payments received under the contract were taxable until the taxpayer recouped her basis, the Court analogized to an annuity contract.[75] *J. Darsie Lloyd*[76] was the first private annuity case to apply the principle of *Burnet v. Logan.* The Board of Tax Appeals in *Lloyd* reasoned that while the present value of an annuity issued by an insurance company regularly engaged in granting annuities or a bank can be determined by the use of mortality tables, when one not engaged in the business of issuing annuities is the obligor, a new element enters the picture. This new element is the uncertainty as to whether or not the obligor will be able to make the payments as agreed, and it renders the value of the obligor's promise (the "amount realized" by the annuitant) unascertainable.[77] Hence no taxable gain is immediate because the obligor's promise is too uncertain to allow a determination of the amount of gain to the annuitant.[78] The important

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74. *Id.* at 412-13.

75. The taxpayer-seller in *Burnet v. Logan* had also received as a bequest her mother's rights to similar 60¢ payments. As to the taxation of these payments, the Court said: "If a sum equal to the value thus ascertained [the value taken for estate tax purposes] had been invested in an annuity contract, payments thereunder would have been free from income tax until the owner had recouped his capital investment. We think a like rule should be applied here." *Id.* at 414.

76. 33 B.T.A. 903 (1936), *nonacquiesced in,* XV-2 CUM. BULL 39 (1936), *nonacquiescence withdrawn and acquiesced in,* 1950-2 CUM. BULL. 3. In *Lloyd,* the annuitant-taxpayer, on April 16, 1930, transferred appreciated corporate stock to his son in exchange for the son's promise to pay him $100,000 per year for the length of their joint lives. The taxpayer did not report any profit from the transaction in his 1930 income tax return for the reason, as stated in the return, that the amount received did not equal the cost of the stock sold. The Commissioner assessed a deficiency, treating the entire capital gain on the disposition of the stock as realized in 1930.

77. Since the time of the *Lloyd* case, the courts have come to recognize what some writers feel is an even more compelling factor in establishing the contingency of private annuity payments—the speculative aspect regarding the span of a single transferor's life. An insurance company which deals with many lives can make a fairly accurate estimate of life expectancy and offset its margin of error in forecasting in one direction in one case by compensating errors in other cases. In other words, an insurance company's gains and losses on annuity contracts because of short-lived and long-lived annuitants respectively average out. In the case of a private annuity, however, the transferee-obligor has only one life with which to work and, therefore, no margin for error. This speculative element makes it impossible to determine with any degree of certainty the number of annuity payments that will be made prior to the annuitant's death. *E.g.,* Fair, McKinster & Zisman, *supra* note 54, at 339 & n.3; Mancina, *The Private Annuity,* 43 TAXES 255, 258-59 (1965).

78. It should be noted that in *Lloyd* and in the cases following *Lloyd* (cited in note 5 *supra*) the promise of the obligor to make the payments was unsecured. While there is no case law for this proposition, it has been suggested that if the obligor's promise were secured, the courts might very well subject the annuitant to immediate taxation. *See, e.g.,* Goldberg, *supra* note 11, at 1228; Middleditch, *supra* note 2, at 474-75; Wallace, *supra* note 2, at 354.

distinction between obligors that are regularly engaged in the business of issuing annuities, and those that are not, is that in the case of the former, laws have been enacted to safeguard their investors. Although Harold C. Lloyd, the obligor, was wealthy, he was not engaged in the business of granting annuities, and, therefore, his investments were not subject to restrictions and supervision as are those of insurance companies and banks.[79] Since the *Lloyd* decision, the principle of *Burnet v. Logan* has been consistently applied to private annuity transactions by the courts.[80] Revenue Ruling 239[81] administratively implemented the principle. In 1962, the IRS ruled that if a transfer of property is made "to an organization, such as a corporation, trust, fund, or foundation (other than a commercial insurance company), which, *from time to time*, issues annuity contracts," in exchange for a lifetime annuity, the transaction is a taxable exchange, resulting in gain to the transferor-annuitant in the year of exchange to the extent that the present value of the payments to be made under the contract exceeds the annuitant's basis in the property transferred.[82] This ruling has, however, been the subject of criticism.[83]

Since the gain implicit in a private annuity transaction was not realized by the annuitant at the time of the conveyance, the problem arose as to when he would be required to report his gain. *Hill's Estate v. Maloney*[84] is the only recorded case dealing with this problem. In that case, consistent with the theory of *Burnet v. Logan*, the court held that after the annuitant had recovered his basis in the property

79. While not mentioned in *Lloyd*, there are several other factors that distinguish insurance companies from the payor of a private annuity: First, an insurance company that writes annuity contracts is required to maintain actuarially computed reserves to meet cash requirements of the contracts. Second, insurance companies are required to maintain minimum capital and surplus balances. Third, the financial position of insurance companies is periodically audited on a surprise basis. Fourth, insurance companies' administrative practices are under constant scrutiny.

80. Cases cited note 5 *supra*.

81. 1953-2 CUM. BULL. 53.

82. Rev. Rul. 62-136, 1962-2 CUM. BULL. 12 (emphasis added). *See* quote from *Dix v. Commissioner* regarding Rev. Rul. 62-137 in note 34 *supra* which applies equally to Rev. Rul. 62-136.

83. *See, e.g.*, Mancina, *supra* note 77, at 259-61, which criticizes Rev. Rul. 62-136 on the following grounds: (1) The IRS fails to give any indication as to how often an organization must have issued annuity contracts before its contracts might be classified as "semi-commercial," resulting in immediate recognition of gain to the transferor. (2) The speculative element involved in estimating the number of payments that the organization will have to make is not altered by the fact that the payor is one of the organizations mentioned in the ruling. (3) If the payor-organization is a marginal business or has a history of wide fluctuations in profits and losses, any evaluation of that promise to make the payments would be meaningless. Grounds (2) and (3), according to Mr. Mancina, may very well fail to overcome the principle of *Burnet v. Logan*.

84. 58 F. Supp. 164 (D.N.J. 1944).

transferred through successive annuity payments, he was then subject to capital gains tax until the annuity payments were equal to the value of the annuity contract. The IRS, in Revenue Ruling 239, specifically adopted this method of taxing private annuities.[85]

The 1954 Revenue Bill, as passed by the House of Representatives, contained a provision relating to private annuities which would have nullified the distinction between private and commercial annuities and taxed private annuities at the event of the contract's execution.[86] The Senate, however, rejected the House bill, stating that the amount of the annuitant's gain was still too uncertain.[87]

In Revenue Ruling 69-74, the IRS seems to be saying that a private annuity transaction is a taxable event.[88] Then, in order to soften the blow, the Service allows the taxpayer-annuitant to spread out his gain ratably over his remaining life expectancy. While this view of the IRS was expected to be issued in the form of a Treasury Regulation, the IRS's stand itself was no surprise in view of the admonition published by the Section of Taxation of the American Bar Association in 1965:

> The Service currently declines to rule on private annuity transactions where the consideration the obligor receives from the annuitant is low basis property that has substantially appreciated in value. The Chief Counsel's office is studying proposals for new regulations which would make it clear that in the Service's view Rev. Rul. 239, 1953-2 C.B. 53 . . . [is] inapplicable to private annuity transactions under the 1954 Code. The current proposals being considered would treat a private annuity transaction as an immediately recognizing transaction and in effect withdraw the Service's acquiescence from the *J. Darsie Lloyd* (33 B.T.A. 903 (1936), Acq. 1950-2 C.B. 3) line of cases.[89]

The validity of the IRS's new method of taxing private annuities, which clearly constitutes a violation of the principle of *Burnet v. Logan*, is discussed at pages 693-97 III *infra*.

E. Loss Deduction

1. *Transfer of Loss Property for a Private Annuity.*—If the basis for the property transferred exceeds the present value of the annuity received in exchange therefor,[90] a loss deduction has been denied by the

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85. 1953-2 CUM. BULL. 53, 54.

86. H.R. 8300, 83d Cong., 2d Sess. § 1241 (1954).

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

88. "The *gain realized on the transaction* is determined by comparing the transferor's basis in the property with the present value of the annuity." 1969-1 CUM. BULL. 43 (emphasis added).

89. 18 ABA BULLETIN OF THE SECTION OF TAXATION 76 (Pt. 1, Jan. 1965).

90. Of the 3 methods used to value annuity contracts (see section II. A. para. 1, at 679 *supra*), the IRS in Rev. Rul. 69-74 uses the method which produces the lowest possible value,

courts[91] on two grounds: First, the purchase of a private annuity is not a "transaction entered into for profit." Second, since no gain is realized on the date of the transfer of appreciated property for a private annuity on the theory that the obligor's promise to make the payments has no ascertainable value, any loss incurred on the transfer is nondeductible for the same reason.[92] From this second ground for denying the loss deduction, it logically follows that under Revenue Ruling 69-74's holding that gain is realized on the exchange, and then reported ratably over the annuitant's remaining life expectancy, the same treatment should be accorded the transfer of loss property for a private annuity.[93] Of course, even the problem under Revenue Ruling 69-74 of having to allocate the loss over the annuitant's life expectancy can be avoided simply by selling the property on the open market, thereby recognizing the loss, and then purchasing the annuity with the proceeds from the sale.

2. *Loss Upon the Premature Death of the Annuitant.*—If the annuitant dies before he has recouped his basis in the property transferred, his estate suffers an economic loss. The courts have generally held that no deduction may be claimed on the annuitant's final return or on his estate tax return. The decisions are based on two grounds: First, the annuitant received exactly what he bargained for—payments *for life*.[94] Second, the purchase of an annuity is not a

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U.S. Life Table 38, thereby increasing the probability that the basis for the property transferred will be greater than the value of the annuity contract.

91. *E.g.*, Evans v. Rothensies, 114 F.2d 958 (3d Cir. 1940).

92. With respect to this second ground for denying a loss deduction, it is arguable that the uncertainty of the obligor's performance should not prevent the recognition of a loss deduction on the exchange. If the amount of gain or loss on a transfer is independent of the annuitant's survival and depends solely upon the value of the annuity when acquired, then although the uncertainty of the obligor's performance may prevent the determination of gain, it is equally clear that the annuitant will have suffered a loss not less than the difference between the basis of the property and the commuted value of the annuity regardless of whether or not the obligor performs his obligation.

93. The major difficulty with this logical extension of Rev. Rul. 69-74's rationale is that in the case of an exehange between related parties it seems to violate § 267 of the Code. While there is no case law on point, § 267 would most likely disallow any loss deduction between related parties.

94. Helvering v. Louis, 77 F.2d 386 (D.C. Cir. 1935), *rev'g* 29 B.T.A. 1200 (1934). In *Louis*, the annuitant had purchased an annuity for the life of her mother, and upon her mother's death prior to the time determined in the mortality tables, the annuitant claimed a loss on her investment on the ground that she had paid for certain payments based on a given number of years of life expectancy, some of which payments did not materialize. The court reasoned that the taxpayer received all tbe payments to which she was entitled under the terms of the contract and that there could be no loss since she received what she bargained for. *Accord*, I.T. 2915, XIV-2 CUM. BULL. 98 (1935).

transaction entered into for profit.[95] Although not adopted by any courts, a third ground for denying the private annuitant a loss deduction has been suggested where the annuity transaction is between related persons: section 267 of the 1954 Code.[96] While the first two grounds have been repeated frequently, they have also been the subject of well-reasoned and persuasive criticism. With respect to the question of whether the annuitant received exactly what he bargained for, an analogy may be drawn to an option wherein the purchaser is not disallowed a deduction when the option lapses even though he has acquired what he bargained for.[97] As to the question of whether the contract is negotiated for profit, it has been suggested that since investing just to receive interest would qualify as a transaction entered into for profit, it is erroneous to distinguish a private annuity because it is based on an assumed interest rate *and* a mortality table.[98] In addition, it may be argued that an investor purchases an annuity for the same reason that he purchases stocks, bonds, or other income-producing property. The motive of security and assurance of regular income is present in both commercial and noncommercial annuity transactions as it is in many other investment transactions which are, nevertheless, regarded as being entered into for profit. In order to accord noncommercial annuity transactions the same treatment as commercial annuity transactions,[99] there should at least be a presumption that the transaction was entered into for profit.[100] A policy consideration overriding our revenue laws has been suggested as a basis for allowing the short-lived annuitant a deduction for his loss: Some provision should be made available for the investor to recover his capital invested, whether it be amortized by depreciation or depletion,

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95. Industrial Trust Co. v. Broderick, 94 F.2d 927 (1st Cir. 1938) (court said purchase of annuities was not a transaction entered into for profit; decedent had sought only security and peace of mind during his life, and upon his death he had received all that he had contracted to receive).

96. Cohen, *supra* note 11, at 498; Wallace, *supra* note 2, at 359.

97. Goldberg, *supra* note 11, at 1221.

98. *Id.*

99. *See* George M. Cohan, 11 B.T.A. 743 (1928) (when transaction entered into for profit, loss deductible where taxpayer forfeited commercial annuity contracts); I.T. 3567, 1942-2 CUM. BULL. 105 (ordinary loss resulted where annuitant surrendered commercial policies for an amount of cash less than his investment). *But see* Early v. Atkinson, 175 F.2d 118 (4th Cir. 1949), *rev'g* 5 P-H 1948 FED. TAX SERV. ¶ 72,586 (D. Va. 1948), where the district court sustained the deductibility of a loss on surrender of commercial annuities but was reversed by the court of appeals on the ground that the primary motive of the annuitant in executing the contracts with commercial companies was desire for security rather than profit.

100. Galvin, *Income Tax Consequences of Agreements Involving Noncommercial Annuities*, 29 TEXAS L. REV. 469, 501-02 (1951).

written off as a loss deduction, or claimed as basis on a sale or disposition.[101] Thus, an inequity existed even under prior law when the annuitant was permitted to apply a high exclusion ratio to each payment received and treat this excluded portion as a tax-free return of capital until his basis for the property transferred was fully recovered.[102] Revenue Ruling 69-74 compounds this inequity by lowering the exclusion ratio, thus making the annuitant recoup his basis over a longer period of time,[103] and requiring the annuitant to report his capital gain at the same time he is recouping his basis.[104] Under Revenue Ruling 69-74, if the annuitant dies any time prior to his life expectancy, he will not only have not recovered his basis but will have already paid a capital gains tax.

III. VALIDITY OF REVENUE RULING 69-74

A. *New Scheme of Taxing Private Annuities*

Revenue Ruling 69-74 violates prior court decisions and even the Service's own former position regarding the income taxation of private annuities.[105] While this prior law existed under the 1939 Code, it had been thought to apply equally to the 1954 Code.[106] The congressional intent behind section 72 of the 1954 Code would call for the application of this prior law to the existing statute, not its inapplicability as

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101. *Id.* at 501.

102. Notes 15-16 *supra*. For an explanation of the theoretical basis underlying the use of the transferred property's fair market value as the annuitant's "investment in the contract," see the text accompanying notes 49-51 *supra*.

103. Rev. Rul. 69-74 uses the annuitant's basis for the property transferred, rather than its fair market value, as the numerator of the exclusion ratio fraction (the "investment in the contract"). This results in basis being recouped in equal yearly portions over the annuitant's remaining life expectancy (10+ years in Rev. Rul. 69-74), instead of in 4+ years (if prior law had been applied to the facts in Rev. Rul. 69-74). For an explanation of the theoretical basis underlying the use of the annuitant's basis in the property transferred as his "investment in the contract," see the text accompanying notes 49-52 *supra*.

104. *See* note 55 *supra* and text accompanying notes 54-55.

105. Notes 73-81 *supra* and accompanying text. Replying to the statement in Rev. Rul. 69-74 that "Revenue Ruling 239, C.B. 1953-2, 53 . . . was issued under different provisions of prior law, [and] is not determinative under section 72(b) of the Code," one author recently stated: "This rationale hardly seems enough to support a change of position after more than 15 years." Ekman, *supra* note 2, at 427 n.8a.

106. In 1955, the IRS even issued a private ruling which applied Rev. Rul. 239 to the 1954 Code and taxed the annuity transaction as follows. The excluded portion (equal to the fair market value of the property transferred divided by the expected return) was received tax-free until the annuitant had recovered his basis. Then the excluded portion was taxable as capital gain until the fair market value of the property was reached. Thereafter the entire excluded portion of each payment was nontaxable. Letter Ruling 9-9-55 ¶ 76, 312 P-H FED. TAX SERVICE 1956, *cited in* Cohen, *supra* note 11, at 495.

decreed in Revenue Ruling 69-74. Congress's purpose in enacting section 72 of the current Code was twofold: (1) to increase the likelihood that the annuitant would recover his cost tax-free, and (2) to eliminate the sudden shock of increased taxation, once cost had been recouped, that existed under the 1939 Code.[107] In an area where Congress has given neither the Treasury Department nor the IRS the power to make law,[108] there is a clear violation of congressional intent. With respect to Congress's first purpose in enacting section 72, Revenue Ruling 69-74 decreases the chances that the annuitant will recover his basis prior to his death by spreading out the recovery period over a greater number of years.[109] With regard to the second purpose of Congress in enacting section 72, in Revenue Ruling 69-74 the portion of each annual payment subject to ordinary income tax suddenly jumped from 2,476.13 dollars to 5,220.00 dollars at the end of the annuitant's life expectancy.[110]

Revenue Ruling 69-74 imposes an additional burden on the annuitant by taxing him at the outset on his capital gain. This unfairly taxes the annuitant on a capital gain before he has recouped his investment. Thus if the annuitant does not live long enough to recover his basis, which is very likely,[111] he is nonetheless taxed on capital gain prior to his realization thereof.

The courts have struck down such unauthorized attempts by the IRS to write new tax legislation. A recent example involved the so-called Kintner regulations,[112] promulgated in 1960, which treated professional organizations as corporations for federal income tax purposes if local law recognized the requisite attributes which distinguish corporations from partnerships.[113] Three years later, after many states had enacted professional corporation laws deliberately

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107. S. REP. No. 1622, 83d Cong., 2d Sess. 11 (1954), *reprinted in* 3 U.S. CODE CONG. & AD. NEWS 4641 (1954); Ekman, *Use of Private Annuities in Estate Planning*, N.Y.U. 17TH INST. ON FED. TAX. 1157, 1158 (1959).

108. INT. REV. CODE of 1954, § 72 does not give the Secretary or his delegate any authority to implement its provisions.

109. *See* note 103 *supra*.

110. See Table 2 of the Appendix.

111. One's life expectancy for annuity purposes is always longer than it is for life insurance purposes. As a typical example, the annuitant's life expectancy for life insurance purposes in Rev. Rul. 69-74 was 6.5231 years (using U.S. Life Table 38 in Treas. Reg. § 20.2031-7(f)), whereas his life expectancy for annuity purposes was 10.1 years (using Table IV in Treas. Reg. § 1.72-9). While this difference reflects the principle of conservatism in the life insurance industry, it means that the annuitant may very well not live 10.1 years.

112. Treas. Reg. § 301.7701-1 (1960), T.D. 6503, 1960-2 CUM. BULL. 412.

113. Treas. Reg. § 301.7701-2(a)(3) (1960); Treas. Reg. § 301.7701-1(c) (1960), T.D. 6503, 1960-2 CUM. BULL. 412.

framed to meet the regulations,[114] the Treasury proposed amendments to the 1960 Kintner regulations[115] completely reversing its earlier position.[116] The amended regulations were once described as saying to professionals, "Try if you want, but it can't be done."[117] Some taxpayers, however, having felt that it could be done, took the issue of the validity of the 1965 regulations to court. To date, the Treasury has been singularly unsuccessful in upholding the validity of the amended Kintner regulations.[118] A common ground for holding the regulations invalid has been that they constitute an attempt by the Treasury to legislate.[119] It is submitted that Revenue Ruling 69-74 likewise constitutes an effort to write new tax legislation rather than interpret the existing statute. Therefore, if its validity is litigated in a court of law, it should be held invalid. Furthermore, the IRS will have a more difficult burden in attempting to sustain the validity of Revenue Ruling 69-74 against attack than did the Treasury in the Kintner cases,[120] since "[t]he courts have recognized a substantial difference between Treasury regulations and mere rulings . . . of the Internal Revenue Service. In the latter case, not even the fiction of implied congressional approval lends weight to such interpretations when they are challenged in court . . . ."[121]

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114. To date, 47 states have some form of authorization for professional associations or corporations. 5 P-H FED. TAXES ¶ 41,608, at 41,621.

115. 28 Fed. Reg. 13750 (1963). These proposed amendments became final in 1965. Treas. Reg. § 301.7701-1 (1965), T.D. 6797, 1965-1 CUM. BULL. 553.

116. The Treasury returned the emphasis from local law to federal law for determining the classification of organizations for federal taxation purposes. For a detailed study of the regulation changes, see Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603 (1965).

117. Thies, *An Open Letter to a Former Secretary of the Treasury*, 46 TAXES 529, 531 (1968).

118. Cochran v. United States, 299 F. Supp. 1113 (D. Ariz. 1969); Kelsey v. United States, 24 Am. Fed. Tax R.2d 69-5468 (W.D. Ark. 1969); Mendelsohn v. United States, 24 Am. Fed. Tax R.2d 69-5471 (W.D. Ark. 1969); Smith v. United States, 301 F. Supp. 1016 (S.D. Fla. 1969); Wallace v. United States, 294 F. Supp. 1225 (E.D. Ark. 1968), *appeal docketed*, No. 19666, 8th Cir., March 10, 1969 (IRS indicated it will not press its appeal, T.I.R. 1019); Holder v. United States, 289 F. Supp. 160 (N.D. Ga. 1968) (IRS indicated it will not appeal, T.I.R. 1019); Kurzner v. United States, 286 F. Supp. 839 (S.D. Fla. 1968), *aff'd*, 413 F.2d 97 (5th Cir. 1969); O'Neill v. United States, 281 F. Supp. 359 (N.D. Ohio 1968), *aff'd*, 410 F.2d 888 (6th Cir. 1969); Empey v. United States, 272 F. Supp. 851 (D. Colo. 1967), *aff'd*, 406 F.2d 157 (10th Cir. 1969).

119. *E.g.*, O'Neill v. United States, 281 F. Supp. 359, 364 (N.D. Ohio 1968), *aff'd*, 410 F.2d 888 (6th Cir. 1969); United States v. Empey, 406 F.2d 157, 167-70 (10th Cir. 1969), *aff'g* 272 F. Supp. 851 (D. Colo. 1967).

120. Cases cited note 118 *supra*.

121. 5 J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 71.03(4), at 7136-37 (1970) (citing cases).

B. *Constitutionality*

The sixteenth amendment of the United States Constitution, adopted in 1913, provides:

> The Congress shall have power to lay and collect taxes on *incomes*, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.[122]

In attempting to define what the term "income" meant, the Supreme Court in *Doyle v. Mitchell Brothers Co.*[123] held that in the case of a sale of property having a known cost, the only income is the excess, if any, of the sale price over the cost.[124] *Burnet v. Logan*[125] adopted the position taken in *Doyle* and held that where it is "not possible to foretell with anything like fair certainty" whether the taxpayer will recover his cost, there is no "income" until he has in fact recouped his cost.[126] Since the Board of Tax Appeals in *J. Darsie Lloyd*[127] applied *Burnet v. Logan* to a private annuity transaction to determine the income tax consequences to the annuitant, the courts and the IRS have consistently followed suit.[128] In *Hill's Estate v. Maloney*,[129] the court, in discussing the application of the *Burnet v. Logan* principle to the income tax consequences of a private annuity transaction, aptly stated:

> The promise of the [obligor] in the instant case to make the payments under the annuity contracts had no ascertainable market value in [the years the transactions took place]. The question of the [obligor's] ability to meet the payments at a later date made the value of the annuities uncertain for purposes of taxation. Until such time as [the annuitant] received the full value of the shares of stock he transferred, or his death prior thereto, the transaction cannot be considered as closed and the entire taxable gain or loss computed. The amount received by him over and above his adjusted cost is taxable gain in the years in which he received it.[130]

With the issuance of Revenue Ruling 69-74, the IRS discarded this equitable and constitutionally-based prior law. Even though the annuitant may very well never recover his capital investment,[131] the

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122. U.S. CONST. amend. XVI (emphasis added).

123. 247 U.S. 179 (1918).

124. *Id.* at 184.

125. 283 U.S. 404 (1931).

126. *Id.* at 412.

127. 33 B.T.A. 903 (1936), *nonacquiesced in*, XV-2 CUM. BULL. 39 (1936), *nonacquiescence withdrawn and acquiesced in*, 1950-2 CUM. BULL. 3.

128. *E.g.*, Evans v. Rothensies, 114 F.2d 958 (3d Cir. 1940); Hill's Estate 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); Rev. Rul. 239, 1953-2 CUM. BULL. 53.

129. 58 F. Supp. 164 (D.N.J. 1944).

130. *Id.* at 172.

131. *See* text accompanying notes 76-78 and note 77 *supra*. *See also* note 111 *supra*.

Service now declares that he must pay a capital gains tax in the year the transaction takes place. Thus, if either the obligor becomes unable to pay or the annuitant dies at any time prior to the annuitant's life expectancy date, the annuitant-taxpayer will have paid a capital gains tax and yet never have recouped his basis. It is submitted that in a private annuity transaction, when it cannot be determined with any degree of certainty that the annuitant will ever recoup his basis in the property transferred, there should be no "income" to the annuitant within the meaning of the sixteenth amendment until he has in fact fully recovered his basis.

IV. CONCLUDING OBSERVATIONS

The question which looms unanswered in the wake of Revenue Ruling 69-74 is: What is the future of private annuities? At first glance, it would appear that there is still mileage left in the private annuity since the advantage uppermost in the minds of those who adopt private annuities, namely reduction of the annuitant's taxable estate, is unaffected by the ruling. It should be remembered, however, that the objective of estate reduction is not always realistically achieved through the use of a private annuity. The property exchanged for the private annuity will be replaced by the total payments made to the annuitant, which will in many cases exceed the fair market value of the property transferred, since the annuity is valued at its actuarially commuted value and not at the total amount of payments to be received over the lifetime of the annuitant. Only if the annuitant does not live out his full life expectancy will estate tax reduction be achieved.

Despite Revenue Ruling 69-74, the private annuity still provides a device whereby an annuitant can exchange a single asset for annual payments in cash which he can invest in diversified holdings. In this manner, he may free himself from the risks of dependence upon a single source of income or may turn non-income producing property into productive yield. This diversification can no longer be made, however, without the imposition of an immediate capital gains tax on the property (usually appreciated) which is exchanged. Ordinary income tax is still imposed on the portion of each payment which represents the interest element and in the aggregate might exceed the capital gains tax which would have been paid had the property been sold. Moreover, under Revenue Ruling 69-74, if the annuitant outlives his life expectancy, the tax consequences are disastrous.[132] One writer recently

132. *See* note 66 *supra* and accompanying text.

suggested that a transfer of property for a private annuity is still beneficial even under Revenue Ruling 69-74 where the property transferred is mortgaged in excess of basis.[133] But even if a court were to approve of this method of treating the transaction, the annuitant is severely limited in the type of property that he can transfer.[134] In view of the many weaknesses inherent in the IRS's position in Revenue Ruling 69-74 in light of past tax policy and practice, it is believed that the courts will refuse to uphold the ruling.*

ROBERT A. SAMS

133. Friedman, *Transfer of Property for Private Annuity Can Still Hold Much Appeal*, 31 J. TAX 264 (1969). The author points out: "While it is problematical whether a taxpayer could secure a court's approval of this method of treating a transaction such as presented in our hypothetical example, it nevertheless illustrates an inherent weakness in the Service's position in *Rev. Rul.* 69-74." *Id.* at 267.

134. Under prior income tax treatment of private annuity transactions, an annuitant could transfer any one of an almost infinite variety of property interests. *See* note 49 *supra*.

* This Note won first-place honors for 1970 in the First National Bank of Chicago's Eighth Annual Estate Planning Competition.

APPENDIX

TABLE 1

INCOME TAX CONSEQUENCES OF PRIVATE ANNUITY TRANSACTION UNDER PRIOR LAW

		Exclusion Ratio = 65.6%			
Year	Total Receipt	Entirely Exempt Under § 72(b)	Capital Gain	Ordinary Income	Accumulated Total Tax (Assuming Annuitant in 50% Bracket)
1	$7,200.00	$4,723.20	-0-	$2,476.80	$1,238.40
2	7,200.00	4,723.20	-0-	2,476.80	2,476.80
3	7,200.00	4,723.20	-0-	2,476.80	3,715.20
4	7,200.00	4,723.20	-0-	2,476.80	4,953.60
5	7,200.00	1,107.20	$3,616.00	2,476.80	7,096.00
6	7,200.00	-0-	4,723.20	2,476.80	9,515.20
7	7,200.00	-0-	4,723.20	2,476.80	11,934.40
8	7,200.00	-0-	4,723.20	2,476.80	14,353.60
9	7,200.00	-0-	4,723.20	2,476.80	16,772.80
10	7,200.00	-0-	4,723.20	2,476.80	19,192.00
11	7,200.00	$4,242.12	481.08	2,476.80	20,550.67
12	7,200.00	4,723.20	-0-	2,476.80	21,789.07
	Indefinite	Indefinite	-0-	Indefinite	Add $1,238.40 more each year

TABLE 2

INCOME TAX CONSEQUENCES OF PRIVATE ANNUITY TRANSACTION UNDER REVENUE RULING 69-74

		Exclusion Ratio = 27.5%			
Year	Total Receipt	Entirely Exempt Under § 72(b)	Capital Gain	Ordinary Income	Accumulated Total Tax (Assuming Annuitant in 50% Bracket)
1	$7,200.00	$1,980.00	$2,743.87	$2,476.13	$1,924.04
2	7,200.00	1,980.00	2,743.87	2,476.13	3,848.08
3	7,200.00	1,980.00	2,743.87	2,476.13	5,772.12
4	7,200.00	1,980.00	2,743.87	2,476.13	7,696.16
5	7,200.00	1,980.00	2,743.87	2,476.13	9,620.20
6	7,200.00	1,980.00	2,743.87	2,476.13	11,544.24
7	7,200.00	1,980.00	2,743.87	2,476.13	13,468.28
8	7,200.00	1,980.00	2,743.87	2,476.13	15,392.32
9	7,200.00	1,980.00	2,743.87	2,476.13	17,316.36
10	7,200.00	1,980.00	2,743.87	2,476.13	19,240.40
11	7,200.00	1,980.00	274.38	4,945.62	21,781.81
12	7,200.00	1,980.00	-0-	5,220.00	24,391.81
	Indefinite	Indefinite	-0-	Indefinite	Add $2,610.00 more each year