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Joseph C. Benage

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COMMENTS

ESTATE PLANNING—PRIVATE ANNUITIES—INCOME TAX CONSEQUENCES
FOR THE ANNUITANT

I. INTRODUCTION

The private annuity has been defined as an "agreement where an individual transfers property to another person, whose business is not selling annuities [or who does not from time to time sell annuities], in exchange for a promise to make fixed, periodic payments for the remainder of the annuitant's life." Typically, the agreement is between family members or between a shareholder and a closely held corporation. In the latter situation the private annuity may be given by a corporation as part of a stock redemption plan in connection with the transfer of control of the corporation to younger family members. Occasionally, the private annuity is used as part of a trust arrangement, especially when the annuitant desires that others have the benefit of the property but is not convinced of their ability to exercise prudent management of the property.

For the older taxpayer the private annuity offers several advantages. It provides the taxpayer with a means of passing property to the objects of his bounty, thereby decreasing his taxable estate at death; yet the taxpayer remains assured of receiving a minimum yearly income for the remainder of his life. If an annuity transaction is structured properly, the

3. In order to obtain income tax deferral, the annuitant may not receive any security for the obligor's promise. See generally text accompanying notes 30-73 infra.
5. See Lazarus v. Commissioner, 513 F.2d 824 (9th Cir. 1975), aff'd 58 T.C. 854 (1972); Bixby v. Commissioner, 58 T.C. 757 (1972).
taxpayer should be able to defer the recognition of capital gain on the transfer of appreciated property. If the transaction is bona fide, at arm's length, free of donative intent, and for an adequate and full consideration in money or money's worth, the taxpayer incurs no gift tax. This also brings the transfer outside the scope of sections 2035-2038 of the Internal Revenue Code. The unrecovered, anticipated annuity payments remaining at the annuitant's death are not included in his taxable estate, and after-transfer property appreciation escapes estate or gift taxation.

The private annuity does have some notable disadvantages, although many of these can be avoided with proper planning. One concern is the unsettled issue of the income tax treatment accorded the annuitant-transferor of appreciated property. Also, the annuitant loses control of the property transferred, which can be particularly important when the property is the annuitant’s major source of income. If he desires to defer capital gain recognition and avoid estate taxes, the annuitant cannot retain an interest in the property transferred nor receive any other security for the obligor's promise. If the annuitant is older, the obligor under the annuity contract may be required to make high periodic payments in order to avoid gift taxes. If received and unconsumed at the time of the annuitant’s death, these payments will increase the annuitant’s taxable estate. The obligor does not get an interest deduction on any portion of his periodic payments. If the annuitant dies prematurely his estate does

7. See text accompanying notes 30-73 infra.
8. Treas. Reg. § 25.2512-8 (1958). A great deal of litigation has centered around the proper method of valuing the annuity. In order to overturn the use of the table selected by the Commissioner, the taxpayer must show that under the circumstances the use of the table is arbitrary and unreasonable. As would be expected, the taxpayer seldom wins this dispute. Compare Dunigan v. United States, 434 F.2d 892 (5th Cir. 1970) and Ellis Sarasota Bank & Trust Co. v. United States, 40 A.F.T.R.2d 77-6239 (M.D. Fla. 1977) with Dix v. Commissioner, 392 F.2d 313 (4th Cir. 1968); Estate of Christ v. Commissioner, 480 F.2d 171 (9th Cir. 1973); and Estate of Lloyd G. Bell v. Commissioner, 60 T.C. 469 (1973). In Rev. Rul. 69-74, 1969-1 C.B. 43, the Commissioner ruled that the appropriate table to be used for valuing a private annuity contract is contained in Treas. Reg. § 20.2031-7 (f) (1958). Subsequently, this regulation was amended and is to be used only for valuation of annuities entered into on or before December 31, 1970. For valuation of annuities entered into after that date, Treas. Reg. § 20.2031-10 (1958) is to be used. See Treas. Reg. § 20.2031-7, T.D. 7077, 1970-2 C.B. 183.
9. The annuitant must be cautious not to structure the transfer in such a way that it appears he retains a life estate. See C. Lowndes, R. Kramer, & J. McCord, supra note 6, at 237.
10. See note 6 supra.
12. Despite the fact that under § 72 the annuitant excludes a portion of each annuity payment and reports only as income the interest component thereof, the obligor is not allowed a corresponding interest deduction. His payments are regarded as capital expenditures. Dix v. Commissioner, 392 F.2d 313 (4th Cir. 1968), aff'g 46 T.C. 796 (1966). Commissioner v. John C. Moore Corp., 42 F.2d 186 (2d Cir. 1930), stands alone to the contrary. However, I.R.C. § 483 (f) (3) may cause a different result if interest is specifically provided for in the annuity agreement.
not get a loss deduction,13 and the obligor will have to decrease his basis in the property acquired from the annuitant.14 On the other hand, if the annuitant should exceed his life expectancy, the obligor probably will not be able to take a loss deduction for payments made in excess of the value of the consideration originally received.15 Under one view, once the annuitant exceeds his life expectancy he no longer gets the capital portion of subsequent annuity payments tax-free.16 The annuitant must also be aware of the possible application of the grantor trust rules if he retains any control over the disposition or enjoyment of the property transferred or the income therefrom.17 In addition, inflation will gradually erode the purchasing power of the annuity payments. Thus, unless the annuitant enjoys other dependable sources of income, what may have seemed a very adequate annual income at the outset gradually may become inadequate.

Obviously, before an individual purchases a private annuity, he must carefully consider the estate, gift, and income tax consequences to the annuitant-transferor and the obligor-transferee. The purpose of this comment is to discuss one aspect of the needed analysis—the income tax consequences to the annuitant.

II. GENERAL TREATMENT OF ANNUITIES

In most instances section 72 of the Internal Revenue Code of 1954 will determine the amount of each annuity payment which must be in-

13. See text accompanying note 154 infra.
14. Rev. Rul. 55-119, 1955-1 C.B. 352. See also Rev. Rul. 72-81, 1972-1 C.B. 99. The first ruling sets forth rules for determining the transferee-obligor's basis for purposes of depreciation and for determining the amount of gain or loss. It initially takes a tentative annuity approach with the basis equal to the value of the prospective payments. However, upon the occurrence of a condition subsequent, the basis is adjusted to actual cost. The second ruling applies Rev. Rul. 55-119, which was promulgated under the 1939 Code, to the 1954 Code.
16. Rev. Rul. 69-74, 1969-1 C.B. 43. Under this ruling each annuity payment consists of two parts: (1) an excluded portion; and (2) an included portion. The excluded portion is computed as:

\[
\text{adjusted basis in property transferred} \times \frac{\text{annual payment}}{\text{annual annuity payment}} \times \frac{\text{life expectancy}}{\text{life expectancy.}}
\]

The included portion consists of two parts: (a) the capital gain portion; and (b) the annuity portion. The capital gain portion is computed as:

\[
\frac{\text{gain from the exchange}}{\text{life expectancy.}}
\]

The annuity portion is the amount which remains. The ruling specifically provides that once the entire capital gain has been fully reported, "subsequent amounts received (after applying the exclusion ratio) are to be reported as ordinary income." The prevailing view prior to Rev. Rul. 69-74 was that once the full amount of gain had been taxed, the excluded portion of any excess payments should not be taxed to the annuitant. See Sams, Private Annuities: Revenue Ruling 69-74—Its Significance, Effect, and Validity, 23 VAND. L. REV. 675, 676 n.11 (1970).
cluded in gross income for the year of receipt.\textsuperscript{18} The entire annuity payment generally must be included, except that amount which represents a reduction or return of premiums or other consideration paid.\textsuperscript{19} Section 72 (b) provides an "exclusion ratio" for this purpose. This ratio has as its numerator the annuitant's "investment in the contract"\textsuperscript{20} and as its denominator the "expected return"\textsuperscript{21} under the contract.\textsuperscript{22} This ratio is then applied against the annuity payment in order to determine the amount to be excluded from gross income. The excess of the annuity payment over the amount excluded must be reported in the annuitant's gross income for the taxable year of receipt.\textsuperscript{23}

The income tax consequences of a private annuity are greatly complicated by the fact that the annuitant typically transfers appreciated property to the transferee-obligor. This means that the annuitant will have some gain realization potential in connection with the transfer. Questions concerning the timing of any realization of gain and its recognition arise, and are further confused by the conflicting interpretations of several applicable Code sections.\textsuperscript{24} There is also a question as to the amount which the annuitant should include as his "investment in the contract" for purposes of section 72 (b)'s exclusion ratio.\textsuperscript{25} The resolution of these questions determines whether the income tax consequences attendant

Amounts subject to § 72 . . . are considered "amounts received as an annuity" only in the event that all of the following tests are met:

(i) They must be received on or after the "annuity starting date" as that term is defined in paragraph (b) of § 1.72-4;

(ii) They must be payable in periodic installments at regular intervals . . . over a period of more than one full year from the annuity starting date; and

(iii) [With certain exceptions] . . . the total of the amounts payable must be determinable at the annuity starting date either directly from the terms of the contract or indirectly by the use of either mortality tables or compound interest computations, or both, in conjunction with such terms and in accordance with sound actuarial theory.

Treas. Reg. § 1.72-2 (b) (2) (1956).


\textsuperscript{20} See text accompanying notes 133-145 infra.

\textsuperscript{21} I.R.C. § 72 (c) (3) provides that expected return shall be determined as follows: "(A) Life expectancy—If the expected return under the contract, for the period on and after the annuity starting date, depends in whole or in part on the life expectancy of one or more individuals, the expected return shall be computed with reference to actuarial tables prescribed by the Secretary.”

The tables mentioned in subparagraph (A) are provided in Treas. Reg. § 1.72-9 (1956). See also Treas. Reg. § 1.72-5 (1956). It is important to note that the Commissioner has ruled that the present value of the annuity contract should be computed according to the tables provided in Treas. Reg. § 20.2031-7 (1958). See note § supra.

\textsuperscript{22} Treas. Reg. § 1.72-4 (a) (1956).

\textsuperscript{23} Id.

\textsuperscript{24} See generally text accompanying notes 90-120 infra.

\textsuperscript{25} See generally text accompanying notes 133-145 infra.
upon use of a particular private annuity justify its purchase by the annuitant.

III. THE TREATMENT OF GAIN

The annuitant typically transfers appreciated property in exchange for the obligor's unsecured promise to make future periodic payments. For estate and gift tax purposes, it is most often advantageous to structure the transaction as an arm's length transfer for full and adequate consideration in money or money's worth. As a result, the annuitant will usually have a gain on the transfer.

Section 1001(a) defines the gain on the disposition of property as the difference between the amount realized and the adjusted basis in the property transferred. The excess of the "amount realized" over the "adjusted basis" constitutes the realized gain. Section 1001(c) states that the entire amount of the gain thus computed should be recognized unless another provision of the Code provides otherwise. Thus, under section 61 it would appear the annuitant should include in his gross income for the year in which he transfers appreciated property to the obligor an amount equal to the excess of the "amount realized" over "his adjusted basis." The annuitant, however, may be able to defer reporting any gain from the transfer if the transaction is properly structured. There are at least three possible grounds for income tax deferral: the open transaction doctrine; the equivalent of cash doctrine; and section 72 proration of gain.

A. The Open Transaction Doctrine

Section 1001(b) of the Code defines the "amount realized" from the disposition of property as "the sum of any money received plus the fair market value of the property (other than money) received." Under the open transaction doctrine, whenever the value of the property received does not have an ascertainable fair market value, the transaction is deemed to be held "open." This means that the transferor need not include the property received as an amount realized in the year of the disposition of appreciated property. Instead, he may first recover his basis in the property transferred as payments are made to him. He does not report any taxable income from the transfer until he has received payments which exceed his basis in the property. The regulations provide that only in rare and extraordinary cases will property be considered to have no ascertainable value.

26. See text accompanying notes 8 and 9 supra.
28. Id.
29. Id.
The open transaction doctrine traces its origin to *Burnet v. Logan*,\(^32\) in which a cash basis taxpayer sold stock to a mining company, receiving in return both cash and a promise that she would receive sixty cents on each ton of ore the company mined. The company had mined large, but varying, amounts of coal for the past twenty years, although under the terms of its lease it was not required to mine any coal. The Supreme Court held that it was impossible to determine with fair certainty the market value of the promise. According to the Court, the taxpayer was entitled to a return of capital before being charged with any taxable income. The Court said that this approach would result in a fairer determination of any income tax liability because it did not require “resort to mere estimates, assumptions, and speculation.”\(^33\) Otherwise the taxpayer might not ever recoup her investment and thus would have been taxed on a gain she never received.\(^34\)

The doctrine was first applied to private annuities in *J. Darsie Lloyd*.\(^35\) There, the father of a wealthy comedian transferred stock to his son and received in return his son’s unsecured promise to make annuity payments. The issue facing the court was whether there was any taxable gain in the year the exchange was made; its resolution depended upon whether the promise of the son to make the future payments had a fair market value within the meaning of section 111 (c) of the Revenue Act of 1928, the predecessor of section 1001 (b).\(^36\) The Court found that it did not have such a fair market value, relying on the fact that the obligor was an individual who, although wealthy at the time of the transaction, might not be able to meet his obligation to pay in the future. The son’s promise was distinguished from one in which the obligor is a company engaged in the business of writing annuity contracts, since the latter would be subject to regulatory requirements which would lend more certainty to the transaction.\(^37\)

The holding in *Lloyd* was later followed in *Frank C. Deering*.\(^38\) In *Deering*, a father transferred stock to his wife and children in return for a small amount of cash and their promises to pay him a life annuity. The father argued and the court agreed that the annuity promise did not have an ascertifiable fair market value. Since the amount of cash received by the father was less than his basis in the property, no gain was realized by the father in the year of the transfer. The court noted that even were he to exceed his life expectancy, there was still no assurance that he would ever recover his cost since the periodic payments depended upon the future.

\(^{32}\) 283 U.S. 404 (1931).

\(^{33}\) Id. at 412.

\(^{34}\) Id. at 413.

\(^{35}\) 33 B.T.A. 903 (1936).

\(^{36}\) The language of section 1001 (b) concerning the “amount realized” has been unchanged since 1924. The present day language was originally enacted in the Revenue Act of 1924, ch. 234, § 202 (c), 43 Stat. 253.

\(^{37}\) 33 B.T.A. at 905.

\(^{38}\) 40 B.T.A. 984 (1939).
financial capabilities of the obligors.\textsuperscript{39} The court emphasized that the obligors in this case were not “a sound insurance company.”\textsuperscript{40}

The Tax Court was not the only court to apply the open transaction doctrine to the receipt of the obligor’s unsecured promise by the annuitant; the Third Circuit did likewise in \textit{Evans v. Rothensies}\textsuperscript{41} and \textit{Commissioner v. Kann’s Estate}.\textsuperscript{42} In \textit{Kann’s Estate} a mother transferred securities to her children in exchange for their unsecured promises to pay her an annuity for life. The court held that where both the annuitant’s life span and the obligor’s ability to pay are uncertain, the obligation should not be ascribed a fair market value. Therefore, the children’s promises were not an “amount realized” by the mother, and she did not realize a gain in the year the transfer was made. The court held that obligations of this kind simply did not come within the purview of the statute.

Perhaps because of this unanimity in court decisions, the Internal Revenue Service withdrew its nonacquiescence to \textit{Lloyd} in 1950.\textsuperscript{43} In 1953 it issued Revenue Ruling 239,\textsuperscript{44} adopting the \textit{Lloyd} rationale. It ruled that there was no gain realized on the transfer of appreciated real property in return for an annuity for life; instead, the annuitant should defer the taxable event until he had recovered his basis in the property transferred. Thus, by 1954 it was well-settled that an annuitant could utilize the cost recovery approach of \textit{Burnet} and \textit{Lloyd} to report the income tax consequences of the transfer.

The application of the open transaction doctrine to the private annuitant was an extension of \textit{Burnet}. In \textit{Burnet}, there were no fixed annual payments; it was even possible that no payments would ever be made. Payments to the transferor were solely within the control and discretion of the obligor. In the private annuity context, on the other hand, the amount of each annuity payment is fixed, and the ultimate amount to be received can be approximated by annuity tables. Nevertheless, courts have determined that the annuitant who receives only the unsecured promise of a non-insurance company obligor has received something analogous to the valueless (in terms of section 1001(b) “fair market value”) promise received by the taxpayer in \textit{Burnet}. This is because the total amount ultimately realized by the annuitant is dependent upon the uncertainty of both his life span and the obligor’s continued financial ability to pay.\textsuperscript{45} The uncertainty of an annuitant’s life span is of course present in every annuity transaction, a fact recognized in \textit{Lloyd},\textsuperscript{46} and is an insufficient
reason, of itself, to hold a transaction open.\textsuperscript{47} The additional uncertainty of the obligor's continued financial capability to pay when his promise is unsecured is apparently the decisive factor in the characterization of a private annuity as open, even though that uncertainty to a degree is present in all unsecured deferred payment transactions.\textsuperscript{48}

Despite the judicial consensus that a private annuity does not have an ascertainable fair market value, in 1969 the Commissioner issued Revenue Ruling 69-74.\textsuperscript{40} This ruling rejects the application of the open transaction doctrine to private annuities. It adopts the view that the annuity promise, even if unsecured, has a fair market value for purposes of section 1001(b) sufficient to require that gain be computed at the time of the transfer. The ruling computes the gain realized as the difference between the annuitant-transferor's basis in the property transferred and the present value of the annuity received, determined from specific actuarial tables provided in the regulations.\textsuperscript{60} No support for this position was cited; in fact, there appears to be none which could have been cited. In 1971 the Tax Court, in a footnote to Edgar v. Commissioner,\textsuperscript{61} agreed that the "general rule" was contrary to Revenue Ruling 69-74 in the case of unsecured private annuities. It was perhaps an indication that Revenue Ruling 69-74 would not be readily accepted by the courts.

\textsuperscript{47} Estate of Lloyd G. Bell v. Commissioner, 60 T.C. 469, 476 (1973); Guaranty Trust Co. v. Commissioner, 15 B.T.A. 20 (1929).

\textsuperscript{48} In this context the courts have tended toward a factor-oriented approach to determine whether the deferred payment contract is the equivalent of cash, rather than whether it has a fair market value. See Comment, \textit{Realization of Income in Deferred Payment Sales}, 34 Mo. L. Rev. 357, 361, 374 (1969). The private annuity is also similar in this respect to transactions in which the taxpayer has acquired highly speculative second mortgage notes at a discount. In this context, the courts have taken a case by case, factor-oriented approach to determine whether or not the obligations are so speculative and the degree of risk inherent in the transaction so high that the amount of profit cannot be fairly determined at the time of the transaction. Commissioner v. Lifitin, 317 F.2d 234 (4th Cir. 1963); Willhoit v. Commissioner, 308 F.2d 259 (9th Cir. 1962); Rissee v. Commissioner, 368 F.2d 965 (10th Cir. 1966); Underhill v. Commissioner, 45 T.C. 489 (1966).

\textsuperscript{49} 1969-1 C.B. 43. The Commissioner had previously issued a ruling which denied an annuitant use of the cost recovery approach where the obligor was an organization which "from time to time issues annuity contracts." Rev. Rul. 62-136, 1962-2 C.B. 12. Dix v. Commissioner, 392 F.2d 813, 316 (4th Cir. 1968), aff'g 46 T.C. 796 (1966), interpreted the "from time to time" language to "embrace only those organizations which write enough annuity contracts to obtain a good spread of the actuarial risk." It has also been ruled that annuity contracts issued by such organizations are sufficiently comparable to individual annuity contracts issued by commercial insurance companies to justify the application of a similar standard of valuation. Rev. Rul. 62-137, 1962-2 C.B. 28, supplemented by Rev. Rul. 62-216, 1962-2 C.B. 30, \textit{clarified in} Rev. Rul. 67-39, 1967-1 C.B. 18, \textit{updated in} Rev. Rul. 72-488, 1972-2 C.B. 38.

\textsuperscript{50} Treas. Reg. § 20.2031-7 (f) (1958). See also note 8 supra. Although not explicit, it is apparently the Commissioner's position that the annuity's actuarial value is also its fair market value for purposes of section 1001(b). Compare the majority and dissenting opinions in Estate of Lloyd G. Bell v. Commissioner, 60 T.C. 469 (1973) \textit{with} 212 Corp. v. Commissioner, 70 T.C. 788 (1973), \textit{appeal dismissed}, [1979] Fed. Taxes (F-H) ¶ 61,000 (3d Cir. April 5, 1979).

\textsuperscript{51} 56 T.C. 717, 742 n.15 (1971).
The nonacceptance of Revenue Ruling 69-74 has since been verified by the proclivity of the courts to either distinguish\(^5\) or ignore\(^6\) it. In *Estate of Lloyd G. Bell*,\(^4\) an elderly couple transferred stock in a closely held farming corporation to their children. In return they received their children's promises to pay to them one-thousand dollars per month for so long as either of them should live. The stock was placed in escrow and the agreement provided for a cognovit judgment in the event of default as security for the promises. The court refused to pass on the validity of either Revenue Ruling 239 or 69-74. The transaction before the court was distinguished simply on the ground that it was "amply secured." Since the parents had received an annuity which had a "fair market value"\(^7\) greater than the adjusted basis of the property transferred, the court held that they had realized a gain. The real issue, said the court, was how this realized gain should be recognized.\(^8\)

The majority in *Bell* distinguished earlier cases which had held that such an annuity contract did not have an ascertainable fair market value by pointing to the presence of the security for the promise. The language of the opinion, however, indicates that an unsecured annuitant might be treated similarly: "It would be manifestly inconsistent to find that the annuity contract had a fair market value for 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."\(^9\) The statement implies that even if the annuity contract were unsecured, if the court utilized the actuarial value of the contract to determine the taxpayer's investment, this would close the transaction for purposes of section 1001. The court would then use that actuarial value as the amount realized—the fair market value of the contract—by the annuitant. The six dissenting judges disagreed with the implications of the majority's state-

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54. 60 T.C. 469 (1973).
55. The court found that the annuity's actuarial value was also its fair market value. *See* text accompanying notes 68-73 *infra*.
56. For a discussion of this issue, see text accompanying notes 121-132 *infra*.
57. 60 T.C. 469, 476 (1973). The court reasoned that for § 72 purposes the "investment in the contract" in an arm's length transfer is the fair market value of the property transferred. In an arm's length transaction the value given and that received will be fairly equal. If the value of the property received is substantially less than the value of that given, the difference must be considered a gift attributable to the family relationship. The amount of consideration paid for the annuity is limited to the actuarial value of the annuity. (Note the resemblance to the logic of United States v. Davis, 370 U.S. 65 (1962).) Having ascertained a fair market value for the annuity for purposes of determining the annuitant's investment in the contract, it would be inconsistent to find it did not have a fair market value for purposes of § 1001.
ment that the "actuarial value of an annuity constitutes its fair market
value in all cases." 58

Revenue Ruling 69-74 was ignored in Fehrs Finance Co. v. Commiss-
ioner. 59 There, a couple owned all of the stock of Fehrs Rental Corpora-
tion (Rental). Their two daughters as sole shareholders formed Fehrs
Finance Company (Finance). The couple then transferred all of the stock
of Rental to Finance in return for a life annuity. Subsequently, Finance
resold all of Rental's stock to Rental for cash and an unsecured promis-
sory note. The issue facing the court was whether the couple had realized
any gain on the redemption transaction. Finance argued that the couple
had realized a gain. It contended that under section 362 the amount of
that gain should be added to its basis in the stock of Rental, with the re-
sult that Finance realized less gain, if any at all, on the subsequent sale
of the stock back to Rental.

The Tax Court disagreed, however, and the Eighth Circuit affirmed.
The Tax Court found that the making of the annuity contracts did not
constitute distributions of property under section 301. It ruled that the
annuities were not the equivalent of cash and did not have ascertainable
fair market values. The court pointed out that the death of either the
mother or the father would terminate the obligation, and emphasized the
fledgling nature of the corporate obligor. 60 The Eighth Circuit dis-
tinguished Bell as involving a secured annuity; incorrectly, it noted that
the corporate obligors in Bell were viable, established corporations, when
actually the obligors in Bell were the two children of the annuitants and
their spouses. The corporate obligor in Fehrs was newly formed, had a total
capitalization of $100,000 plus an unsecured promissory note, and yet was
obligated to pay out $70,000 per year. 61 The case is interesting for its ap-
parent disregard of 69-74 when the annuity promise is unsecured, at least
where the question is whether there have been distributions of property
within the meaning of section 301 rather than whether there has been an
amount realized under section 1001 (b). It suggests that when the obligor is
a corporation rather than an individual, courts may look to its financial
stability as a factor in determining whether the obligation given the an-
nuitant has an ascertainable fair market value. In an earlier decision the
financial condition of the obligor had not been considered a factor when
the obligor was an individual.62

58. 60 T.C. 469, 476 (1973) (Simpson, J., dissenting).
59. 487 F.2d 184 (8th Cir. 1973), aff'd 58 T.C. 174 (1972).
60. 58 T.C. at 190-92.
61. 487 F.2d at 190.
62. J. Darsie Lloyd v. Commissioner, 33 B.T.A. 903, 905 (1936). In that
case the obligor was a wealthy comedian. The court said:
But here a new element enters the computation, 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 payments actually arrives. This diff-
culty might not be so great in the case of a sound insurance company
regularly engaged in granting annuities or, perhaps, in the case of a
In 1978 the Tax Court once again was confronted with the issue of whether an annuity promise had a fair market value for purposes of section 1001 (b). In 212 Corp. an elderly couple transferred property to a newly formed corporation, 212 Corporation, in return for a joint and survivor annuity. The corporation, owned by two sons and a son-in-law of the couple, then leased the property to the Arthur F. Schultz Company (Schultz), which was wholly owned by the husband. The scheme was for Schultz to rent the property from 212 Corporation, which would then use the rentals to pay the annuity as well as taxes and insurance on the property. The court found that the parties had entered the transaction of their own volition, that the price had been set by the husband, that the rents to be paid by Schultz were calculated and expected to be sufficient to fund the annuity, and that 212 Corporation had no other source of income. As security for the transaction the parties agreed that the annuity payments would be a charge upon rents and profits of 212 Corporation from property conveyed to it; that 212 Corporation could not mortgage or sell any of the property without first obtaining the annuitants’ consent; and that 212 Corporation would authorize a confession of judgment against it in the event of default.

The majority of the court, following Bell, held that the transaction was “closed” and that the entire gain was taxable in the year the exchange was made. The opinion utilized the actuarial value of the annuity as the amount realized (the “fair market value” of the annuity promise) by the annuitant for the purpose of computing gain realized under section 1001 (b). One dissent found that the annuity promise did not have an ascertainable fair market value. It disagreed with the majority’s use of actuarial tables to determine the annuity’s fair market value, attacking the notion that it was inconsistent to find a “fair market value” for purposes of section 72 while finding no “determinable” value for purposes of section 1001.

In sum, these cases indicate that a private annuitant should not retain security for the obligor’s promise. Even though one case deemed the transaction to be open despite the retention of some security interest, keeping a security interest risks immediate gain recognition on the trans-

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63. 70 T.C. 788 (1978).
64. Id. at 798-802.
65. Id. at 804 (Fay, J., dissenting). Evans v. Rothensies, 114 F.2d 958 (3d Cir. 1940), was relied upon for this conclusion. There, even though 2,956 of 3,000 shares transferred were placed in escrow as security for the annuity, the court found that the annuity had no ascertainable fair market value.
66. 70 T.C. at 806 n.5 (Fay, J., dissenting).
67. Evans v. Rothensies, 114 F.2d 958 (3d Cir. 1940).
fer of appreciated property. The private annuitant should also be aware of Revenue Ruling 69-74 and the implications of the majority opinions in Bell and 212 Corp. If their approach is applied, the private annuity will be deemed closed even where there is no security for the obligor’s promise. Fehrs Finance offers some authority for the proposition that in the Eighth Circuit no gain is realized on the transfer if the annuitant receives only the unsecured promise of the obligor and if the obligor is a corporation of questionable financial stability.

The annuitant should also consider that he may be required to include an actuarial value of the annuity promise, whether secured or not, as its fair market value for purposes of determining the amount of gain realized under section 1001 (b). This holds true despite the fact its actuarial value may bear little relation to its actual value in the market (if, indeed, there is a market for private annuity contracts). While it is generally accepted that actuarial tables are an appropriate method of valuing obligations when the only major contingency is the length of the recipient’s life (i.e., a secured private annuity), the additional contingency present in the case of unsecured annuities of the obligor’s future ability to pay is not accounted for by actuarial tables. Its presence would mean that the fair market value of the promise would be an amount discounted below its actuarial value. The observation made by the majority opinion in Bell that it would be 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,” is not persuasive. It is questionable whether the taxpayer’s investment in the private annuity contract should be determined according to the value of the property he received in exchange. Further, section 72 and section 1001 address

68. See note 47 supra. But see 212 Corp. v. Commissioner, 70 T.C. 788, 804 (1978) (Fay, J., dissenting).

69. The position of Rev. Rul. 69-74 cannot rest on the same inconsistency relied on by the majority in Bell and adopted sub silentio in 212 Corp., i.e., that it would be inconsistent to find that the annuity promise had a fair market value for purposes of determining the annuitant’s investment in the contract under § 72 (c), but that it did not have a fair market value for purposes of § 1001 (b). See notes 57-58, 65-66, 68 and accompanying text supra; see notes 70-73 and accompanying text infra. This is because Rev. Rul. 69-74 ruled that the annuitant could only include his adjusted basis in the property transferred as his investment in the contract, rather than its fair market value. Whether the actuarial value of the annuity would equal the amount for which a willing seller and buyer would exchange the property, each fully aware of the facts and under no pressure, is purely a matter of chance. In fact, the long-standing judicial position has been that the unsecured private annuity contract does not have an ascertainable fair market value for purposes of § 1001 (b). See text accompanying notes 39-43 supra.

70. 60 T.C. at 476.

71. The approach used for valuing the investment in the contract seems to be based on the “presumptively equal” approach of United States v. Davis, 370 U.S. 65 (1962). There, pursuant to a property settlement executed prior to a divorce, a husband transferred appreciated property to his wife in return for

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different issues. In other contexts, courts have found that the fact that the promise given to the annuitant had a fair market value for one purpose

the release of her marital rights. The Court found that the exchange was a taxable event. Therefore, it was required to determine the amount of gain realized by the husband on the transfer. The problem which faced the Court was how to value the marital rights released by the wife—the amount realized by the husband. The Court found that:

Absent a readily ascertainable value it is accepted practice where property is exchanged to hold... that the values "of the two properties exchanged in an arms-length transaction are either equal in fact, or are presumed to be equal." Once it is recognized that the transfer was a taxable event, it is more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences.

Id. at 72-73. In Davis, once the exchange was made the parties' relationship in connection with the exchange ended. This is not true of the private annuity where the parties' relationship continues. If the promise is unsecured, the ultimate amount to be received by the annuitant is dependent upon both his life span and the continued financial capabilities of the obligor. The Davis principles are further distinguishable in both Bell and 212 Corp. where the annuities were found to be amply secured. In Davis, the exchange was made at arm's length. In Bell, on the other hand, the court specifically found that a gift element was present; and in 212 Corp. the court found that the sale price had been set by the annuitant.

72. Section 72 addresses the reporting of income flowing from the annuity itself. It provides a mathematical formula that allows the annuitant to report any income derived from the annuity over his life expectancy. It was designed to relieve the annuitant of the unfairness which resulted under the 1939 Code. S. REP. No. 1622, 83d Cong., 2d Sess. 11, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, 4640. Section 1001 addresses the realization and recognition of gain on the disposition of property which has appreciated in value. The gain realized is to be recognized except as elsewhere provided in the Code. The regulations indicate that this exception clause does not refer to § 72. Treas. Reg. § 1.1002-1 (1957).

Section 72 is premised upon expected return over an actuarial life expectancy. The annuitant is allowed to recover the consideration paid for the annuity tax-free over the period of his life expectancy, after which he receives tax-free that portion of each annuity payment which had previously represented a recovery of the consideration paid for the annuity. In the absence of a gift element, the full consideration paid for the annuity is the fair market value of the property transferred.

The open transaction doctrine (§ 1001) is based upon the ultimate actual return. If the fair market value of that which is received (the annuity promise) cannot be fairly determined, then the annuitant may first recover his basis in the property transferred before reporting any gain.

It has been noted that it is inconsistent to determine a fair market value for the annuity promise received and to use that value to determine the annuitant's investment in the contract for purposes of the § 72 exclusion ratio, while not finding a fair market value for the annuity promise received for purposes of the amount realized under § 1001. Estate of Lloyd G. Bell v. Commissioner, 60 T.C. 469, 476 (1973); Croft & Hipple, Planning Lifetime Property Transfers: Private Annuities, Installment Sales and Gift-Leasebacks, 11 REAL PROP., PROB. & TR. J. 253, 264 (1976). This apparent inconsistency could be a result of the fact that both the exclusion ratio of § 72 and the open transaction doctrine of § 1001 are designed to afford the taxpayer fair income tax treatment. It may not be unfair to value the annuitant's investment in the contract according to an actuarial "fair market value" of the annuity received, since § 72 deals in expectations. Also, since § 72 is to the annuitant's benefit and some value must be
did not prevent a finding that it did not have an ascertainable fair market value, for purposes of section 1001 (b).73

B. The Equivalent of Cash Doctrine

Section 451 (a) of the Code74 specifies that an item of gross income is included in gross income for the year of receipt unless the accounting method of computing taxable income elected by the taxpayer specifies a different period. Section 44675 allows a taxpayer to elect among several accounting methods of computing taxable income, subject only to the basis on which the taxpayer regularly computes his income in keeping his books, and, if he has no regular method or the method used does not clearly reflect income, the method prescribed by the Secretary of the Treasury.76 Section 446 (c) specifically lists the cash receipts and disbursements method as one permissible method.

Ordinarily, individual taxpayers utilize the cash receipts and disbursements method.77 The cash basis taxpayer reports as income for the taxable year any cash received, as well as any property (other than cash) received which is either the “equivalent of cash” or “constructively received.”78 The latter doctrine requires the taxpayer to report as income an item which is subject to his “unconditional capacity to reduce to possession,” even though he has not physically received the item.79 Generally, the equivalent of cash doctrine requires the taxpayer to report as income property received which, like money, is “freely and easily negotiable so that it readily passes from hand to hand in commerce.”80 Stated otherwise, the property must be “readily convertible into cash.”81

given the investment in the contract, the contract’s actuarial “fair market value” may be as good as any. However, especially if the contract is unsecured, its actuarial value may bear very little relation to its fair market value. The valuation of the contract for purposes of § 1001 carries with it an additional consequence. Since the transaction is closed, the annuitant faces the possibility that a court will treat as ordinary income any amounts subsequently received which exceed the discounted amount included as the fair market value of the annuity. See notes 146-151 and accompanying text infra.

73. Burnet v. Logan, 283 U.S. 404, 411, 412 (1931) (contract found to have a fair market value for purposes of federal estate tax, but not for purposes of determining gain); Estate of Hurlburt v. Commissioner, 25 T.C. 1286 (1956) (contracts found to have a fair market value for purposes of state inheritance tax, but not for purposes of determining gain).

74. I.R.C. § 451 (a).
75. I.R.C. § 446.
76. I.R.C. § 446 (a), (b).
77. 2 J. MERTENS, supra note 30, § 10.01.
81. Hirst v. Commissioner, 572 F.2d 427, 439 (4th Cir. 1978) (Wintee, J.,...
The private annuitant initially receives, as part or all of the consideration for his transfer of property, the obligor-transferee's promise to pay fixed, periodic sums. In this regard the private annuity is analogous to other deferred payment transactions to which the courts have applied a cash equivalency test, rather than a mere "fair market value" test, to determine whether the promise received constitutes an amount realized by the cash basis taxpayer under section 1001 (b).82 Traditionally, courts

dissenting); Edelman v. United States, 329 F.2d 950, 954 (Cl. Ct. 1964); Watson, Jr. v. Commissioner, 69 T.C. 544, 549 (1978). See also Estate of Lloyd G. Bell v. Commissioner, 60 T.C. 469, 477 (1973) (dissenting opinion) (the obligation must be readily transferable in commerce).

The government may claim that under the economic benefit theory income must be reported in the year the property is received despite the fact that the property fails to meet the requirements of the equivalent of cash doctrine. In United States v. Drescher, 179 F.2d 863 (2d Cir.), cert. denied, 340 U.S. 841 (1950), an officer and director of a corporation received from the corporation an annuity contract which named him as the annuitant. The court found that the policy was to remain in the company's possession until the taxpayer reached age 65, that the taxpayer's salary was not decreased because of the purchase of the annuity contract, that the taxpayer was not given the option to receive cash, and that as long as the company retained possession of the contract the taxpayer could not accelerate the date when monthly payments should commence. The contract was not assignable, was free from claims of creditors, and was not salable; it had no cash surrender value, no loan value, and did not entitle the annuitant to a distribution of surplus. The Second Circuit found that the taxpayer had received income which he was required to report because he had "received as compensation for prior services something of economic benefit which he had not previously had." Id. at 865.

The economic benefit doctrine is distinguishable in the private annuity context. The doctrine appears to be a peculiarity of the 'employer-employee' relationship. See, e.g., McEwen v. Commissioner, 6 T.C. 1018 (1946). But see Anastasio v. Commissioner, 67 T.C. 814 (1977). Further, the doctrine does not concern the amount realized under § 1001 (b); it addresses only § 61 gross income.

82. Comment, supra note 48, at 361, 374. The justification for this approach is that it would be inconsistent to require a cash basis taxpayer to include as an amount realized property which is not the equivalent of cash and thus not income to him. Johnston v. Commissioner, 14 T.C. 560 (1950). In Warren Jones Co. v. Commissioner, 60 T.C. 663, 668 (1973), rev'd, 524 F.2d 788 (9th Cir. 1975), the Tax Court refused to close a transaction because the promise received by the transferor was found not to be the equivalent of cash. The court added that it would be unfair to require the taxpayer to report all the gain in the year the contract was made and thus pay the tax before receiving the deferred payments. It stated that the amount of capital gain on the transfer would be permanently limited to the difference between the taxpayer's basis and the discounted value of the promise received (the amount realized).

It is not clear whether the taxpayer's method of reporting income stems from the realization section, § 1001 (b). In Western Oaks Bldg. Corp. v. Commissioner, 49 T.C. 365 (1968), an accrual method taxpayer was required to include the face amount of the contract rather than its fair market value as the amount realized. There is some indication that § 1001 (c)'s recognition provision brings the taxpayer's method of reporting into play. This latter approach is supported by Watson v. Commissioner, 69 T.C. 544, 548-49 (1978), in which the court said:

Section 1001 (a) provides that the gain from the sale of property shall be the excess of the amount realized therefrom over the property's adjusted basis... . .

For cash basis taxpayers . . . this section 1002 [now section 1001 (c)]
have held that if the deferred payments are evidenced by a contract, and no notes, mortgages, or other evidence of indebtedness are given or accepted as part of the transaction, the contract is not the equivalent of cash.83 Also, the obligation must be negotiable to be considered the equivalent of cash and thus included as an amount realized.84 Because a mere contract to make deferred payments was not considered the equivalent of cash, it did not constitute an amount realized to the cash basis taxpayer. Therefore, the transferor-recipient of an unsecured deferred payment promise was able to defer reporting any gain on the transfer until he had received cash or its equivalent which exceeded his basis in the property transferred. In practical effect, this allowed the taxpayer to use the cost recovery method of Burnet, albeit for a different reason.

Recently, this approach has come under attack. A requirement of "negotiability" has been rejected by some courts and seems to be outmoded as a per se test of cash equivalency.85 The trend appears to be in the direction of a factor-oriented approach which emphasizes the obligation's liquidity. This is exemplified by Cowden v. Commissioner,86 in which the court adopted the following test for determining whether a promise to pay is the equivalent of cash:

[I]f a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation.87

This test was adopted by the Tax Court in its opinion in Warren Jones Co. v. Commissioner,88 but the court went on to find that the amount of discount required to transfer the deferred payment contract was too great to allow a finding of cash equivalence.89

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exception brings into play section 451(a) . . . . Under the accompanying section 1.451-1(a), Income TaxRegs., a cash basis taxpayer shall include in gross income amounts "when actually or constructively received." We hold that the Irrevocable Banker's Letter of Credit . . . was "property" which had a "fair market value" within the meaning of section 1001(b). . . . [I]t was equivalent to cash.

85. Cowden v. Commissioner, 289 F.2d 20, 24 (5th Cir. 1961); Warren Jones Co. v. Commissioner, 524 F.2d 788, 790 n.4 (9th Cir. 1975); Heller Trust v. Commissioner, 382 F.2d 675, 681 (9th Cir. 1967).
86. 289 F.2d 20 (5th Cir. 1961).
87. Id. at 24.
88. 60 T.C. 663 (1973), rev'd, 524 F.2d 788 (9th Cir. 1975).
89. Id. at 668-70.
that must be included as an amount realized in the year it is received.

The several opinions written by the members of both the Tax Court and the Ninth Circuit in Warren Jones Co. v. Commissioner held that if the fair market value of a deferred payment obligation received in an exchange could be ascertained, that fair market value must be included as an amount realized in the year it is received.

90. The logic of Johnston v. Commissioner, 14 T.C. 560, 564 (1950), was set out as follows: "The petitioner is on a cash basis and to realize gain must receive during the taxable year cash or its equivalent in excess of his basis before he can have any taxable gain." (Emphasis added.)

The court in Western Oaks Bldg. Corp. v. Commissioner, 49 T.C. 365, 376-77 (1968) stated:

In determining the income derived from the sale of property by a cash method taxpayer, a right to receive future income is not included in the computation of the "amount realized" under Section 1001 (b) unless that right is the equivalent of cash. . . . This is true even though for other purposes that right may be considered to have a fair market value. . . . Where the right is the equivalent of cash, it is included in the income of a cash method taxpayer in the year of receipt at its fair market value.

But see Clodfelter v. Commissioner, 48 T.C. 694, 700 (1967), aff'd, 426 F.2d 1391 (9th Cir. 1970), where the court said: "Also, these and related provisions [Sections 1001, 1002, and 453] make it clear the amount of any gain from a sale . . . must be determined as of the time of the sale, irrespective of whether the seller is on the cash or accrual basis. . . ."

91. 524 F.2d 788 (9th Cir. 1975), rev'd 60 T.C. 663 (1973).

92. But see Warren Jones Co. v. Commissioner, 60 T.C. 663, 673 (1973) (Quealy, J., dissenting).
$41,000 of payments by the buyer. This meant that the transferor could have readily converted into cash only $76,980 of the $183,000 face value of the contract. The seller's adjusted basis in the apartment building was $61,913.34. The court also found that the purchaser was solvent, that the only evidence of the indebtedness was the contract, that such contracts were regularly bought and sold in the locality, that funds and buyers were available in the local area for investment in this type of contract, and that the contract had an ascertainable fair market value.

The taxpayer argued that he had not realized any gain in the year of the sale since his adjusted basis in the property was greater than the amount of cash received. He contended that the contract for deferred payments was not an amount realized in the year the sale was effected since it was not the equivalent of cash. The Commissioner, on the other hand, argued the contract was the equivalent of cash since it had an ascertainable fair market value and was readily marketable. He contended that it was "property (other than money)" under section 1001 (b) and to the extent of its fair market value constituted an amount realized. The argument logically followed that because the cash received plus the fair market value of the contract exceeded the taxpayer's adjusted basis in the asset transferred, the taxpayer had realized a gain which he was required to recognize in the year of the transfer. The Tax Court agreed with the taxpayer, holding that the amount of discount required to sell the contract was too great to allow a finding of cash equivalence.93

It concluded that to include the contract as an amount realized would be contrary to the cash basis taxpayer's method of reporting income; the contract had no tax significance to the taxpayer.94 The opinion is consistent with the manner in which the courts have traditionally approached the computation of a cash basis taxpayer's amount realized under section 1001, only if the obligor's promise to make future payments is the equivalent of cash is it included at its fair market value as an amount realized.95

A concurring opinion disagreed with the majority's analysis. It posited that the issue turned on whether the contract was "property received" by the taxpayer on the sale and not whether the contract was the equivalent of cash. If it was "property received," then it must be included at its fair market value as part of the amount realized by the taxpayer on the sale. This differs from the majority's view that if the contract is the equivalent of cash, it is included at its fair market value as part of the amount realized by the taxpayer. The test for the determination of whether the contract is "property received" appears to be whether it is "sufficiently marketable or has a fair market value sufficiently ascertainable as to constitute 'property' within the meaning of section 1001 (b)."96

93. Id. at 668.
94. Id. at 669-70.
95. See text accompanying note 82 supra.
This approach appears to combine features of both the open transaction doctrine and the equivalent of cash doctrine.97

A dissenting opinion refused to analyze the facts in terms of whether the contract received by the taxpayer was the equivalent of cash.98 Rather, it analyzed the facts solely in terms of whether the sale was "closed" or "open," that determination depending upon several factors of which marketability was the most important.99 Another dissent concluded that the majority's "cash equivalence" test for determining whether a contract is an amount realized under section 1001(b) was wholly unjustified.100 It took the position that because a willing buyer would purchase the contract, albeit for a discounted amount, it must be included as an amount realized in the year the sale was made.

In reversing the Tax Court, the Ninth Circuit relied heavily on a statutory analysis of section 1001 and the enactment of section 453 of the

97. The "sufficiently marketable" language connotes cash equivalency while the "has a fair market value sufficiently ascertainable as to constitute 'property'" language is merely a definition of property received which passes muster under the open transaction doctrine. The sentence is written in the disjunctive, but it is unclear whether the dissent is saying that a finding of either is sufficient or that they are identical standards.

This "property received" test is developed more fully in Comment, *The Doctrine of Cash Equivalency as Illustrated by Land Sale Contracts and Notes Received for Services Rendered*, 22 U.C.L.A. L. Rev. 219, 241-48 (1974), where the writer says that it is supported by congressional debate, revenue rulings, and court decisions. Marketability and convertibility into cash are noted as being the two requisites to a finding of "property received." But the concurring opinion in *Warren Jones* found that the contract was not "property received," even though the court found that the contract was marketable and immediately convertible into cash. It is difficult to see under these definitions of the "property received" test how a conclusion contrary to that which would result under a "cash equivalency" standard could be reached. A "property received" test merely begs the question of what is "property received" under § 1001(b).


99. Marketability is the key factor in the determination of whether an obligation received is the equivalent of cash. The open transaction doctrine addresses the issue of whether the obligation received by the taxpayer has an ascertainable fair market value for purposes of § 1001(b). It requires that all circumstances be reviewed to ascertain whether the ultimate amount to be received under the obligation is sufficiently certain so that, in fairness, the taxpayer can be required to calculate gain immediately upon its receipt. It applies whether the taxpayer uses the cash or accrual method of reporting income. It appears that the dissent in *Warren Jones* is trying to add to the open transaction equation a factor which could be applicable only to the cash basis taxpayer.

Under this approach, the private annuitant can arguably defer gain realization on the ground that the promise, whether or not secured, is not marketable. As the dissent said, marketability "implies a recognizable group of prospective buyers so that it can be said that the property is of a type that 'commonly change[s] hands in commerce.'" *Id.* at 671 (Tannenwald, J., dissenting), quoting *Johnston v. Commissioner*, 14 T.C. 560, 565 (1950). Note that this is the definition of "equivalent of cash." See cases cited at note 80 supra.

100. 60 T.C. at 673, 674 (1973) (Quealy, J., dissenting).
Code.\textsuperscript{101} It concluded that section 1001 requires that "if the fair market value of property received in an exchange can be ascertained, that fair market value must be reported as an amount realized."\textsuperscript{102} It is an interpretation of section 1001 which the Internal Revenue Service long had advocated, but with little or no success.\textsuperscript{103} The opinion also cites several decisions which purportedly support its position;\textsuperscript{104} in fact, all are distinguishable. Some of these cases merely support a broad definition of what constitutes income to a cash basis taxpayer;\textsuperscript{105} others do not discuss

\textsuperscript{101} 524 F.2d at 791, 792 (1975). The court said that the question presented was essentially one of statutory construction. \textit{Id.} at 791 n.6. The predecessor of § 1001 (b) was § 202 (b) of the Revenue Act of 1919, ch. 18, § 202 (b), 40 Stat. 1057, 1060. It provided: "When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value . . . ."

The Revenue Act of 1921, ch. 136, § 202 (c), 42 Stat. 227, 230, changed the section to provide: "On an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value . . . ."

Congress once again changed the language in the Revenue Act of 1924, ch. 234, § 202 (c), 43 Stat. 253, this time to the language which now appears in § 1001 (b): "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

The court in \textit{Warren Jones Co. v. Commissioner} concluded that:

There is no indication whatsoever that Congress intended to retain the "readily realizable market value" test from the 1921 statute as an unstated element of the 1924 Act . . . . We cannot avoid the conclusion that in 1924 Congress intended to establish the more definite rule . . . . if the fair market value of property received in an exchange can be ascertained, that fair market value must be reported as an amount realized.

524 F.2d at 792.

\textsuperscript{102} 524 F.2d 788, 792 (1975). At least one commentator has reached a contrary conclusion. Comment, \textit{The Doctrine of Cash Equivalency as Illustrated by Land Sale Contracts and Notes Received for Services Rendered}, 22 U.C.L.A. L. Rev. 219, 259 (1974), states: "This section [present day § 1001(b)] could be viewed as the current forward point of a continuing congressional desire to be less rigorous in taxing property exchanges by taxing only such property that can be considered the equivalent of cash."

It should be noted that the Ninth Circuit did not need to go as far as it did in its holding. It could have merely held that since the contract was marketable and had a fair market value, it was the equivalent of cash and therefore an amount realized under § 1001 (b), despite the fact it was readily marketable only at a substantial discount. \textit{See Heller Trust v. Commissioner}, 24 T.C.M. 1663 (1965), \textit{aff'd}, 382 F.2d 675 (9th Cir. 1967), in which it was held that the deferred payment contracts had a fair market value of 50% and to that extent were includable in the taxpayer's income in the year of sale.

\textsuperscript{103} Comment, \textit{supra} note 102, at 239, 240.

\textsuperscript{104} 524 F.2d at 798, 794.

\textsuperscript{105} In \textit{Heller Trust v. Commissioner}, 382 F.2d 675 (9th Cir. 1967), the taxpayer-seller was required to include as income in the year he had sold duplexes the fair market value (50% of face value) of deferred payment contracts given by the purchasers. The case does not stand for the proposition that if the contract received has an ascertainable fair market value, that fair market value must be reported as an amount realized. The decision specifically finds that the contracts were income (cash or its equivalent) to the cash basis taxpayer. Therefore, they were included at their fair market value as an amount realized.
the impact of the equivalent of cash doctrine on section 1001 (b), apparently because the obligation involved was not a mere contractual promise of the obligor and therefore was clearly the equivalent of cash.\textsuperscript{106}

More convincing is the court's discussion of section 453 of the Code.\textsuperscript{107} The court found this section to be intended to relieve taxpayers of any hardships imposed on them by section 1001 (b). With regard to those dispositions which do not qualify for section 453 treatment, the court quoted from a 1926 Senate Report on the Revenue Act of 1926:

[D]eferred-payment contracts . . . are to be regarded as the equivalent of cash if such obligations have a fair market value.

In consequence, that portion of the initial payment and of the fair market value of such obligations which represents profits is to be returned as income as of the taxable year of the sale.\textsuperscript{108}

This language offers strong support for the court's decision. It is unclear, however, why this language had not previously been applied to an interpretation of the general realization and recognition rules of section 1001—at least in a deferred payment context—even though it had been on the books since 1926. The court also claims that its conclusion does not conflict with that of Cowden v. Commissioner.\textsuperscript{109} While this may be true, the logic employed in the two cases cannot be reconciled. The Ninth Circuit would, at best, find that any property with a fair market value is the equivalent of cash for purposes of section 1001 (b) to the extent of its fair market value.\textsuperscript{110} Cowden, on the other hand, clearly gives the equivalent of cash doctrine a primary role in the determination of the amount realized under section 1001 (b): "[I]f a consideration . . . is the equivalent of cash it will be subjected to taxation to the extent of its fair market value."\textsuperscript{111}

This same dichotomy has surfaced in the area of private annuities. Early decisions dealing with the realization and recognition of gain by the private annuitant held that the obligor's unsecured promise had no ascertainable fair market value, thus entitling the annuitant to use the cost recovery approach of Burnet.\textsuperscript{112} The courts did not concern themselves with the issue of cash equivalence, apparently because even if the contract were considered to be the equivalent of cash, it did not have a fair market value which could be included as an amount realized. The decisions were phrased in terms of the open transaction doctrine, but

\textsuperscript{106} E.g., In re Steen, 509 F.2d 1398 (9th Cir. 1975) (installment payment contract secured by a first mortgage).

\textsuperscript{107} This section was originally enacted in the Revenue Act of 1926, ch. 27, § 212 (d), 44 Stat. 23.


\textsuperscript{109} Cowden v. Commissioner, 289 F.2d 20 (5th Cir. 1961).

\textsuperscript{110} 524 F.2d at 791 n.6.

\textsuperscript{111} Cowden v. Commissioner, 289 F.2d 20, 23 (5th Cir. 1961).

\textsuperscript{112} See text accompanying notes 35-42 supra.
were replete with phraseology indicative of the cash equivalency doctrine. This failure to keep the two doctrines distinct was usually of no consequence, since in the great majority of cases a contract which does not have an ascerttainable fair market value is also not the equivalent of cash.

In two recent Tax Court cases, however, the dissent argued that a mere determination that the contract has an ascertainable fair market value is not sufficient to require that it be included as an amount realized without a further finding that it is also the equivalent of cash. In Estate of Lloyd G. Bell, the majority refused to allow the taxpayer to use the cost recovery approach of Burnet. The opinion made no reference to the equivalent of cash doctrine. The six dissenting judges agreed that the presence of the security interest could provide a basis for distinguishing J. Darsie Lloyd, but refused to join in the opinion that therefore gain was automatically required to be reported in the year of the transfer. The dissent stated that the promise received also had to be the equivalent of cash, and concluded that because of the "peculiar characteristics" of the private annuity, the obligor's promise could not be considered the equivalent of cash.

The same issue again confronted the Tax Court in 212 Corp., in which the majority followed Bell. Again, six judges dissented believing that even if the obligation received has an ascertainable fair market value, that fair market value is realized by a cash basis taxpayer only if the obligation is the equivalent of cash. It is unclear from the dissenting opinions, however, what effect a finding of no cash equivalency would have on the realization and recognition of gain by the annuitant. Although five dissenting judges stated that a cash basis taxpayer does not include a contract as an amount realized unless it is the equivalent of cash, and then proceeded to find that the annuity contract was not the equivalent of cash, they also required the annuitant to report gain immediately, albeit pro rata over his remaining life expectancy. Only one of the dissenters appeared to recognize this inconsistency and reach the proper conclusion that if the contract were found not to be the equivalent of cash, the taxpayer should report any gain under the cost recovery method. In light of the foregoing statements, the annuitant probably should not rely

113. 60 T.C. 469 (1973).
114. The majority found that the secured annuity promise had an ascertainable fair market value equal to its actuarial value. Although there was no finding or discussion of cash equivalence, it is questionable whether even a secured private annuity promise is the equivalent of cash. Thus, it seems as if the majority of the Tax Court would apply a fair market value test to determine whether a private annuity contract is an amount realized under § 1001 (b). The decision may be even more significant than that in Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975), since in Warren Jones there was a specific finding that the contracts were marketable.
115. 70 T.C. 788 (1978).
116. Judge Fay wrote one dissent. Id. at 804. Judge Simpson wrote another in which four judges concurred. Id. at 810.
117. Id. at 804, 810 (Fay, J., dissenting).
on the equivalent of cash doctrine to defer the realization and recognition of gain, despite the fact the annuity promise is probably not the equivalent of cash. Traditionally, courts have not analyzed the private annuity in terms of the equivalent of cash doctrine, and they do not seem willing to do so in the future. Revenue Ruling 69-74 ignores the taxpayer's method of reporting income. In addition, it is questionable whether the courts will continue to apply any cash equivalence test to section 1001(b) of the Code. The annuitant can at least argue that even under the fair market value test followed by the Ninth Circuit in Warren Jones, the transaction should be held open and that income should be reported from the sale by the cost recovery method. This should hold true even if the annuity is secured because in Warren Jones the contract was found to be marketable and to have a fair market value. While the private annuity contract may have a fair market value if it is secured, it still may not be marketable. If it is not marketable, the transaction falls outside the facts of Warren Jones and arguably should be held open. Bell and 212 Corp., however, refused to accept this argument in a secured private annuity context where there was no finding of marketability.

C. Section 72 Proration of Gain

It should be apparent by now that if the private annuity is held open the annuitant may use the cost recovery method to report any gain on the transfer. The question which then arises is whether the annuitant must report the entire amount of gain realized in the year the property is transferred if the transaction is closed. The authorities are in conflict, partially because of the uncertain impact of the cash equivalency doctrine.

In Revenue Ruling 69-74 the Commissioner ruled that a transaction in which the taxpayer received an unsecured private annuity in exchange for the transfer of appreciated property was closed. However, the annuitant was only required to report a portion of the realized gain in the year of the transfer. The applicable portion of the ruling states:

118. See 212 Corp. v. Commissioner, 70 T.C. 788 (1978); Estate of Lloyd G. Bell v. Commissioner, 60 T.C. 469 (1973); note 114 supra.
119. 1969-1 C.B. 43.
120. See text accompanying notes 118-114 supra. If the taxpayer's method of reporting income is not relevant to a determination of his amount realized under § 1001(b), consistency would require an accrual method taxpayer to include the fair market value rather than the face value of the contract. See Western Oaks Bldg. Corp. v. Commissioner, 49 T.C. 365 (1968). But see Rev. Rul. 79-292, 1979-39 I.R.B. 18, in which the Service ruled that an accrual basis taxpayer must include the face amount, rather than the fair market value, of a note received as an amount realized from the sale of a home. It was noted that valuing the note and treating it as property received at its fair market value "would be inconsistent with the well-established principle that an accrual method taxpayer includes in income amounts which it has a right to receive."
121. 1969-1 C.B. 43.
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. This will enable the annuitant to realize his gain on the same basis that he realizes the return of his capital investment.

This aspect of Revenue Ruling 69-74 was not followed in *Estate of Lloyd G. Bell*.

There, the taxpayers-annuitants transferred stock in a closely held farming corporation to their children and their spouses in return for a private annuity. The court found the obligors' promises to be amply secured and refused to pass on the validity of Revenue Ruling 69-74 since it involved an unsecured annuity promise. The court also closed the transfer in the year the exchange was made, distinguishing *J. Darsie Lloyd* as involving an unsecured promise. The taxpayers were required to include the entire amount of their realized gain as income in the year the annuity transaction was executed.

Six dissenting judges agreed that the secured promise was a sufficient ground for closing a transaction and would deny the annuitant the use of the cost recovery method. They disagreed with the majority's decision that therefore the entire gain realized should be reported in the year the transfer was made. Instead, they relied on the equivalent of cash doctrine and a statutory analysis of section 72 to argue that gain should be deferred. They concluded that because of the "peculiar characteristics" of the private annuity promise, it was not the equivalent of cash and that gain should be prorated in accordance with section 72.

The logic of the dissent is faulty and illustrates the uncertainty concerning the proper interrelationship between the equivalent of cash doctrine and section 1001. The problem with the logic is that if an annuitant does not include as an amount realized his right to receive future income because it is not the equivalent of cash, there is no gain realized which need be reported. For the cash basis annuitant, if only property which is cash or cash-like constitutes an amount realized under section 1001 (b), then no gain is realized until he has received payments in excess of his basis in the property transferred. Thus, the question of how to report the gain should never arise in the year the promise is received, since there is no gain realized in that year to report.

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122. 60 T.C. 469 (1973).
123. *Id.* at 477.
124. *Id.* at 478.
125. *Bell* was followed in 212 Corp. v. Commissioner, 70 T.C. 788 (1978). There, five judges joined in one dissent, *id.* at 810, and determined that because of the "peculiar characteristics" of the private annuity, the annuitant should be able to prorate any gain. Another dissent noted the inconsistency between the majority decision and the Tax Court's decision in *Warren Jones*; however, it recognized that even if the promise had an ascertainable fair market value (for purposes of the open transaction doctrine), the taxpayer still effectively reports any gain according to the cost recovery method. This assumes the use of a cash equivalency test for purposes of § 1001 (b).
It appears that the reporting of gain realized by an annuitant under a section 72 proration approach is unwarranted. The logic behind a proration approach might be consistent with the goals of section 72\textsuperscript{126} and the desire to treat the annuitant fairly might be noble; yet, the fact remains that neither section 72\textsuperscript{127} nor its predecessor\textsuperscript{128} addressed the recognition of gain realized on the transfer of appreciated property for an annuity. Both treat only the reporting of gain generated by the annuity contract itself.\textsuperscript{129} Also, a proration approach forces the annuitant, in effect, to utilize the installment method provided for in section 453 of the Code, ostensibly an elective provision.\textsuperscript{130}

Whatever the ultimate conclusion about whether a section 72 proration approach should be used,\textsuperscript{131} the decisions and the rulings would

\textsuperscript{126} Section 72 was designed to alleviate the erratic and harsh treatment of annuitants who had recovered their basis in the annuity by spreading the tax-free portion of the annuity income evenly over the annuitant’s life. The exclusion ratio does not change even after the annuitant’s life expectancy has been attained. S. REP. No. 1622, 83d Cong., 2d Sess., reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, 4640, 4641; H. R. REP. No. 1397, 83d Cong., 2d Sess., reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4017, 4034.

\textsuperscript{127} Section 72 addresses the reporting of the income generated by the annuity contract itself. See generally Stewart, Revenue Ruling 69-74 Partially Repealed, Sub Silentio, by Treasury Regulation § 1.1011-2(c), Example (8), 24 Mercer L. Rev. 585, 602-06 (1973).

\textsuperscript{128} Rev. Act of 1934, § 22 (b) (2), 48 Stat. 687. This became part of the 1939 Internal Revenue Code as ch. 1, § 22 (b) (2), 53 Stat. 10, which provided: Amounts received as an annuity under an annuity or endowment contract shall be included in gross income; except that there shall be excluded from gross income 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 for such annuity (whether or not paid during such year), until the aggregate amount excluded from gross income under this chapter or prior income tax laws in respect to such annuity equals the aggregate premiums or consideration paid for such annuity.

\textsuperscript{129} Stewart, supra note 128, at 605, says that the legislative history of § 72 makes it clear that Congress was only trying to make two changes in the law: (1) [A]bandonment of the arbitrary 3 per cent rate approach of prior law, and (2) abandonment of the “heads I win, tails you lose” position of the government under prior law and to accord the annuitant the same chance to come out ahead tax-wise by living longer than his life expectancy, as he had for loss tax-wise under the prior provision if he died before recovering his investment in the annuity.

This legislative history of § 72 takes much of the wind out of the assertion of Rev. Rul. 69-74 that “Revenue Ruling 259, 1953-2 C.B. 53, which was issued under different provisions of prior law, is not determinative under section 72 (b) of the Code.”

\textsuperscript{130} For sales of property which meet the requirements of § 453 (and if the taxpayer so elects), the taxpayer may report as income from the transaction a proportion of the installment payments actually received in that year. The proportion is determined by the amount of the gross profit realized or to be realized when the property is paid for, divided by the total contract price. Treas. Reg. § 1.453-5 (a) (1958).

\textsuperscript{131} A simple example will illustrate the different reporting approaches utilized in Rev. Ruls. 69-74 and 239. Assume that A transfers property to B in return for a private annuity, the periodic payments being $5 yearly. A’s basis in the property transferred is §10, and the property’s fair market value is $20 at
be much clearer if several basic propositions were kept in mind. First, if the annuity is held open the annuitant should be entitled to use the cost recovery approach of reporting gain. Second, if the court utilizes a cash equivalency test for purposes of section 1001 (b) and the transaction is closed, but the property received by the annuitant is not the equivalent of cash, then the annuitant should be entitled to use the cost recovery method. Third, if the transaction is closed and the property received is found to be the equivalent of cash (under a cash equivalency approach) or if the transaction is closed and a fair market value approach is used, the question then becomes whether section 72 proration applies. Revenue Ruling 69-74, the dissent in Bell, and one dissent in 212 Corp. say it does; Revenue Ruling 239, the majority of the Tax Court in Bell, and 212 Corp. disagree.\(^\text{132}\)

The time it is transferred. Assume further that \(A\) has a life expectancy of 10 years. Note that in the Rev. Rul. 239 computation, the fair market value of the property transferred is used as \(A\)'s investment in the contract (the numerator) in his exclusion ratio, while in the Rev. Rul. 69-74 computation, \(A\) is only allowed to use his adjusted basis in the property transferred as the numerator in his § 72 exclusion ratio. This issue is discussed in more detail in text accompanying notes 133-145 infra.

Under the approach of Rev. Rul. 239, \(A\)'s § 72 (b) exclusion ratio is 20/50, or 2/5. Thus, \(A\) treats each annual payment of $5 in the following manner: (a) 2/5 of $5 (\$2) is excluded until \(A\) has recovered his cost; 3/5 of $5 (\$3) is ordinary income; then (b) 2/5 of $5 (\$2) is capital gain until an amount equal to the fair market value of the property transferred has been received, and 3/5 of $5 (\$3) is ordinary income; finally (c) 2/5 of $5 (\$2) is excluded and 3/5 of $5 (\$3) is ordinary income. Several cases are in accord with the approach of Rev. Rul. 239. See Commissioner v. Kann's Estate, 174 F.2d 357 (3d Cir. 1949); Evans v. Rothensies, 114 F.2d 958 (3d Cir. 1940); J. Darsie Lloyd v. Commissioner, 93 B.T.A. 903 (1936). Note, however, that in each of these cases the transaction was held open.

Under the approach of Rev. Rul. 69-74, \(A\)'s § 72 (b) exclusion ratio is 10/50 or 1/5. Thus, \(A\) treats each annual payment of $5 in the following manner: (a) 1/5 of $5 (\$1) is excluded, and \(10/10 = \frac{\text{total gain}}{\text{life expectancy}}\) is capital gain, and 3/5 of $5 (\$3) is ordinary income until \(A\) reaches life expectancy; then (b) 1/5 of $5 (\$1) is excluded and 4/5 of $5 (\$4) is ordinary income.

The dissent in Estate of Lloyd G. Bell v. Commissioner, 60 T.C. 469, 476 (1973), and one dissent in 212 Corp. v. Commissioner, 70 T.C. 788, 810 (1978), would adopt the proration approach of Rev. Rul. 69-74, except that they would use the fair market value of the property transferred as the annuitant's investment in the contract and would allow the annuitant who exceeds his life expectancy to exclude the capital gain portion. Note that Bell and 212 Corp. held that the entire amount of the gain was realized and recognized in the year the property transfer was made.

132. In connection with the deferred recognition of gain realized, the cash basis annuitant could argue that even though he must include as an amount realized the fair market value of the annuity promise (irrespective of whether it is the equivalent of cash), under § 1001 (c) he does not recognize that gain unless it is reportable under §§ 446 and 451. Presumably, under this approach the annuitant who transferred property with a fair market value of $50 and in which he had an adjusted basis of $25 for an annuity with a present value of $50 would immediately realize a gain of $25. However, none of this gain would be recognized until he began to receive payments which exceeded his basis of $25.
D. Section 72 Exclusion Ratio—"Investment in the Contract"

The numerator in the section 72 exclusion ratio is the annuitant’s investment in the contract.\textsuperscript{133} The greater its value in relation to the denominator, the expected return, the higher the ratio and accordingly the greater the amount of the annuity excluded. Most annuitants thus would find it to their advantage to have a high "investment in the contract."

Prior to 1969 it was generally recognized that an annuitant’s "investment in the contract" for private annuity transactions was equal to the fair market value of the property transferred at the date of the transfer, despite the fact that he reported no gain until he had received payment which exceeded his basis in the property transferred.\textsuperscript{134} This approach was consistent with the view of the private annuity as composed of two separate transactions: the sale of property and the subsequent purchase of an annuity with the proceeds from the sale. Thus, "the aggregate amount of . . . consideration paid for the contract"\textsuperscript{135}—the investment in the contract—was presumed to be equal to the fair market value of the property transferred.

In 1969, however, the Internal Revenue Service issued Revenue Ruling 69-74.\textsuperscript{136} It limits the annuitant’s "investment in the contract" to his adjusted basis in the property transferred. Since the typical private annuity involves the transfer of appreciated property, the adjusted basis

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One problem with this approach is that the annuitant still faces the problem that since the transaction is immediately closed, a court is likely to require him to report as ordinary income subsequent amounts received by him which exceed the fair market value of the annuity promise. See text accompanying notes 146-151 infra.

More importantly, the argument does not appear valid. Section 1002 was incorporated into § 1001 (c) in 1976. Treas. Reg. § 1.1002-1 (c) (1957) provides:

Exceptions to the general rule [of recognition] are made, for example, by sections 351 (a), 354, 361 (a), 371 (a) (1), 371 (b) (1), 721, 1031, 1085, and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated. . . . Sections 446 and 451 clearly would not fall within the sweep of the "underlying assumption" of § 1001 (c).

\textsuperscript{133} I.R.C. § 72 (c) (1) (2) defines "investment in the contract." See also Treas. Reg. § 1.72-6 (1956).

\textsuperscript{134} Hill's Estate v. Maloney, 58 F. Supp. 164 (D.N.J. 1944); de Canizares v. Commissioner, 32 T.C. 345 (1959), acq. 1959-2 C.B. 4; John C. Moore Corp. v. Commissioner, 15 B.T.A. 1140 (1929), aff'd, 42 F.2d 186 (2d Cir. 1930); Rev. Rul. 239, 1953-2 C.B. 53. Cf. Ware v. Commissioner, 159 F.2d 542 (5th Cir. 1947) (suggesting that annuitant's basis in the contract is the adjusted basis of the property transferred). See also Middleditch, supra note 6, at 161; Sams, supra note 16, at 684.

\textsuperscript{135} I.R.C. § 72 (c) (1) (A).

\textsuperscript{136} 1969-1 C.B. 43.
of the property is usually less than its fair market value. The lesser value, in turn, renders a less favorable exclusion ratio for the annuitant. The Service’s position in Revenue Ruling 69-74 rests, presumably, upon a treatment of the private annuity analogous to that of a tax-free exchange of property for an annuity. There is no basis in the Code for treating the exchange as tax-free. Indeed, Revenue Ruling 69-74 itself recognizes that it is not tax-free because it requires a proration of gain over the annuitant’s life expectancy.137 The ruling, however, fails to explain its departure from prior law other than to state: “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.”

It is not difficult to understand the Commissioner’s distaste for a sale-purchase approach. Under traditional private annuity treatment an annuitant does not realize any gain on the transfer of appreciated property until he has recovered his basis in the property.138 If the annuitant is allowed to include the full fair market value of the property transferred as his investment in the contract, he is able to exclude a portion of each annuity payment which does not represent a return of basis nor an amount of appreciation in value of the property on which the annuitant has been taxed. However, the Commissioner’s alternative, to include only the annuitant’s adjusted basis, appears to be an overkill since Revenue Ruling 69-74 also ruled that the transaction was closed and that the gain thus realized should be reported ratably over the annuitant’s remaining expected life span. As noted by several commentators, theoretical consistency would allow the annuitant to add to his investment in the contract each year the amount of gain recognized in the prior year.139 While this “series of transactions” approach may have theoretical appeal, it is not very practical.

It is unlikely that courts will accept either the Revenue Ruling 69-74 “exchange” or the “series of transaction” approach. Two decisions of the Tax Court subsequent to Revenue Ruling 69-74 support this proposition. The Tax Court in Estate of Lloyd G. Bell140 found that the private annuity at issue was closed for tax purposes in the year the exchange was made and distinguished Revenue Rulings 239 and 69-74 as involving “unsecured” private annuities. This distinction is largely illusory; the important fact is that in both Revenue Ruling 69-74 and Bell the transfer was closed, and the cost recovery approach was denied the taxpayer. In Bell,141 both the majority, which held the entire gain taxable in the year

137. See generally Stewart, supra note 127, at 611-17.
138. See text accompanying notes 35-42 supra.
139. Raiborn & Watkins, Critical Analysis of Private Annuity Taxation, 50 Taxes 11, 19-21 (1972); Sams, supra note 16, at 685, 686; Sullivan, supra note 6, at 475, 476.
140. 60 T.C. 469 (1973).
141. Id. at 472, 473.
of transfer, and the dissent, which adopted a proration approach similar to that in Revenue Ruling 69-74, found the investment in the contract to be equal to the amount required to purchase the annuity. In an arm’s length transfer that amount is equal to the fair market value of the property transferred. However, if the transaction constitutes in part a gift, the investment in the contract is limited to the present value of the annuity received, irrespective of the fair market value of the property transferred.

Use of the annuitant’s adjusted basis as his investment in the contract may have a greater justification if the private annuity is deemed open and gain recognition is deferred until the annuitant’s basis is recovered. However, use of fair market value is more consistent with the general intent of section 72. It seems that the latter approach, consistent with section 72, should be used for purposes of its provisions, rather than an approach which, though more consistent with section 1001, is contrary to the intent of section 72. The decisions are unanimous in following the sale-purchase approach and allowing the annuitant to include the fair market value as his investment in the contract, at least if no element of gift is

142. Id. at 478, 479 (Simpson, J., dissenting).
143. The court noted that while the taxpayers claimed the fair market value of the property transferred was $207,600, they also conceded that the actuarial value of the annuity received was only $142,573. It concluded that this difference could only be attributable to the family relationship, deemed this difference to be a gift, and thus limited the taxpayer’s “investment in the contract” to the actuarial value of the annuity contract of $142,573. Id. at 473. Since most private annuities involve intra-family exchanges, the “investment in the contract” will usually be limited to the actuarial value of the annuity received, irrespective of the fair market value of the property transferred.

Bell was followed in 212 Corp. v. Commissioner, 70 T.C. 788, 798 (1978). There, the court said:

It is now well settled that in cases in which appreciated property is transferred in consideration for an annuity, the annuitant’s investment in the contract is the fair market value of the property transferred. . . . However, such rule is applicable only when the parties are dealing at arm’s length. When the fair market value of the property transferred substantially exceeds the value of the annuity received, such excess is deemed to be a gift in the absence of proof to the contrary, and the taxpayer’s investment in the contract is limited to the value of the annuity. . . . Thus, we must find both the value of the annuity and the value of the properties transferred in exchange for it.

This approach assumes that the value of the annuity received can be fairly determined, an assumption that is suspect, especially if the annuity promise is unsecured. See text accompanying notes 35-73 supra.

144. See note 72 supra. It may appear unjust to allow the annuitant to use a fair market value of the property transferred for purposes of the § 72 exclusion ratio, while not for determining a fair market value for the annuity promise received. But the same result could obtain if a cash equivalency test is applied to § 1001(b). The promise may have a fair market value, but may not be the equivalent of cash. In that case, the annuitant could obtain the benefit of the fair market value of the property transferred (assuming no gift element is present) for purposes of § 72, but would not report any gain until he had received cash or its equivalent greater than his basis in the property transferred.
Thus, despite Revenue Ruling 69-74, the annuitant should include the fair market value of the property as his investment in the contract. He has reasonable grounds for doing so whether the transfer is deemed closed and gain is immediately recognized or prorated, or the transfer is held open and gain is deferred until the annuitant has recouped his basis.

IV. Other Considerations

A. The Nature of the Gain

Another good reason for structuring the private annuity in a way that minimizes chances that it will be closed for tax purposes in the year of the transfer is to insure to the annuitant capital gain-treatment of his entire gain potential. It is clear that if the transaction is held open all payments received by the annuitant will be treated as giving rise to capital gain, just as if they had been received at the time of the transfer. If the transaction is closed, however, it is likely that a court would require an annuitant to report as ordinary income subsequent amounts received which exceed the amount included as the fair market value of the annuity promise. The basis for this treatment is that the subsequent amounts are not received in connection with the sale or exchange of a capital asset.

An annuitant confronted with this dilemma might be able to convince the court that the doctrine of Arrowsmith v. Commissioner should apply to him; requiring that if the gain he originally reported when the transaction was closed was capital gain, any gain subsequently reported by him which arose out of the same transfer of property should also be capital. In Arrowsmith, two taxpayers liquidated a corporation and divided the proceeds. Partial distributions of the proceeds were made during the years 1937 to 1940, and the profits therefrom were reported as capital gains. In 1944 a judgment was rendered against the liquidated corporation which the two taxpayers were required to pay. They reported the payment as an ordinary loss. The Supreme Court denied the taxpayers ordinary loss treatment, holding that despite the principle that each taxable year is a separate unit for tax accounting purposes, the 1937 to


146. Waring v. Commissioner, 412 F.2d 800, 801 (3d Cir. 1969); Estate of Meade v. Commissioner, 489 F.2d 161, 163 (5th Cir. 1974); Dennis v. Commissioner, 175 F.2d 274, 285 (5th Cir. 1973); In re Steen, 509 F.2d 1398, 1403, 1404 (9th Cir. 1975); Westover v. Smith, 173 F.2d 90 (9th Cir. 1949).

147. Tombari v. Commissioner, 299 F.2d 869, 893 (9th Cir. 1962). See also Warren Jones Co. v. Commissioner, 524 F.2d 788, 791, 792 (9th Cir. 1975).


149. 344 U.S. 6 (1952).
1944 liquidation transaction events should be considered together in order to classify the nature of the 1944 loss. Thus, the Court found that the loss was capital since the original transaction out of which it arose and of which it was a part was a transaction entitled to capital gain and loss treatment.

The annuitant should also consider Lowe v. Commissioner,150 which concerned a gain recognized after the transaction had been closed. There the taxpayer sold all of the stock of a corporation in 1955, receiving in return a down payment and a promissory note for the balance of the purchase price. The stock was retained by the taxpayer as security. Three years later the purchaser defaulted on the remaining payments. He reconveyed the stock to the taxpayer, and the taxpayer retained $22,500 of the amount paid by the purchaser toward the purchase price as consideration for the release of the purchaser from further liability. Finding that the transaction was closed in 1955, the court dealt with the proper characterization of the $22,500 received by the taxpayer in 1958. It concluded that the subsequent "adjustment" or "revision" of the sale was not a transaction separate from the original transaction. The later transaction was "part and parcel" of the original sale.151 Thus, the original transaction being capital in nature, the gains later received were also capital even though the gains were received in years after the transaction was regarded as closed.

It seems reasonable that a private annuitant should receive the same treatment. If he is required to compute, realize, and recognize gain in the year the exchange is made, it is on the basis of estimates of his life span that he does so. Typically, the obligor is an individual and the annuitant receives only his unsecured promise; there is no guarantee of the obligor's future ability or willingness to pay. Indeed, even if the annuity promise can be ascribed a fair market value, that value is certain to be discounted from the actuarial value. Under these circumstances, it seems reasonable to argue that the fact that the annuitant eventually receives more than that amount originally deemed to be the fair market value of the contract for purposes of section 1001 (b) is no more than a subsequent adjustment or revision of the original exchange. The later gain arose from the same transaction wherein the property was transferred; it was "part and parcel" of that exchange. Therefore, its nature as capital or ordinary gain should be determined by reference to the original exchange.

B. Loss Deductions

The taxpayer's estate is not entitled to claim a loss for the premature death of the annuitant. Three reasons have been advanced for this position: (1) the transaction was not entered into for profit;152 (2) the tax-

150. 44 T.C. 363 (1965), acq. 1966-1 C.B. 2.
151. Id. at 374.
152. Industrial Trust Co. v. Broderick, 94 F.2d 927, 930 (1st Cir. 1938).
payer received what he contracted for; \textsuperscript{153} and (3) it would be asymmetrical to permit a deduction for mortality gain while excluding from income any mortality gain.\textsuperscript{154} Often applicable will be section 267 of the Code which disallows deductions for losses from sales or exchanges of property between "related" taxpayers.

The annuitant may not claim a loss deduction upon the transfer of depreciated property to the obligor. \textit{Evans v. Rothensies},\textsuperscript{155} the leading case for this proposition, based its conclusion on the open transaction doctrine. The court felt that no loss was realized since the annuity contract did not have a sufficiently ascertainable fair market value for purposes of section 1001. In this regard, Revenue Ruling 69-74 is in the annuitant's favor. If the open transaction doctrine is not applied to the private annuity, the annuitant should be able to immediately recognize a loss on the transfer of depreciated property. Here again, however, section 267 is likely to have an unfavorable impact.

C. Attribution of Income to the Annuitant

Rather than make an outright transfer, the annuitant frequently will prefer to transfer property to a trust for the benefit of his children. He may prefer a trust arrangement because of instability in the family, the youth of the children, or some other reason that leads him to question their ability to manage the property in a proper manner. If the annuitant chooses to structure the private annuity in this fashion he must be careful to avoid the application of the grantor trust rules.\textsuperscript{156} This series of rules provides that when the grantor of a trust has retained substantial dominion or control over the income of a trust, that income should be taxed to the grantor and not to the trust.

\textit{Lazarus v. Commissioner},\textsuperscript{157} offers an example of these adverse tax consequences to the annuitant. In \textit{Lazarus}, the taxpayers transferred a shopping center to the recently formed N & V Realty Corporation (N & V) in return for its stock. They next established a trust with Arawak Trust Co. Ltd., a Bahamian corporation, as trustee. After an initial funding of $1,000, the stock of N & V was transferred to the trust in exchange for its unsecured promise to pay the taxpayers a joint and survivor annuity of $75,000 per year. The trustee then sold the N & V stock to another Bahamian corporation, Aruba Bonaire Curacao Trust Co. Ltd. (ABC), which it represented and managed, in exchange for a nonassignable promissory note to pay $1,000,000 in twenty years plus annual interest of $75,000 per year. The Tax Court found and the Ninth Circuit agreed that the transaction was not in substance a sale in

\begin{thebibliography}{99}
\bibitem{153} Helvering v. Louis, 77 F.2d 386, 387, 388 (D.C. Cir. 1935).
\bibitem{154} Goldberg, \textit{supra} note 6, at 1220, 1221.
\bibitem{155} 114 F.2d 958 (3d Cir. 1940).
\bibitem{156} I.R.C. \textsection\textsection 671-678.
\bibitem{157} 513 F.2d 824 (9th Cir. 1975), \textit{aff'd} 58 T.C. 854 (1972).
\end{thebibliography}
consideration for an annuity, but rather was a transfer in trust subject to a reservation of income. Therefore, under section 677(a), the taxpayers were deemed owners of the trust and were taxed on the income therefrom under section 671.

Essential to the courts' conclusions were findings that all of the documents executed were part of a prearranged plan; the courts therefore construed these documents together. In holding that the transaction was, in substance, a transfer in trust with a retained life estate, the courts said that no private annuity was ever created. The trust merely served as a conduit for the proceeds of the sale of N & V stock from ABC to the taxpayers in a manner calculated to defer capital gain recognition and obtain gift and estate tax savings.

Another illustration of the application of the grantor trust rules is *Bixby v. Commissioner*158. In *Bixby* seven trusts were established, each bearing the name of a taxpayer-family member whose descendants were to be benefited by that trust. On the same day that the trusts were created, each family member for whom a trust was named purchased from his "namesake" trust a private annuity. Each in turn transferred to "his" trust stock in a closely held family corporation. Each trust was to accumulate and reinvest trust income until the death of the person for whom the trust was named. Substantial powers over the income, corpus, and trustees of the trust were retained by each taxpayer-family member. Under these circumstances, the Tax Court found that the annual payments were not annuity payments. Instead, the court said that because of the degree of control maintained by each taxpayer-family member over his "namesake" trust, the payments were actually distributions falling within section 677(a)(1). Thus, the income of the trusts was taxable to the taxpayer-family members under section 671. The court felt that the test of control should be applied strictly in the area of private annuities "in order to curb abuses."

Revenue Ruling 68-183159 sheds some light on this problem. It gives the example of a grantor of a trust who transferred to the trustee corporate stock for the benefit of his grandchildren. The trustee was given discretion to determine the needs of the beneficiaries and to pay out as much as those needs required. The grantor subsequently transferred more corporate stock to the trust, receiving in return an annuity, the yearly amount of which depended upon the current income yield of the entire property held in trust. The only funds available for making the payments were those received as income of the trust, unless the stock were to be converted to cash. The Commissioner ruled that under these circumstances the grantor had made a contribution of stock to the trust with a reservation of the income for life. Thus, the grantor was treated as the owner

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159. 1968-1 C.B. 308.
of the trust under section 677 and taxed on all the income therefrom under section 671.

In some cases, income has been held taxable to the transferor when he has transferred property outright to another and the periodic payment that he is to receive in return is dependent upon the amount of income produced from the property transferred. In such circumstances the transferee-obligor is considered a trustee who is required to account to the grantor for the income received from the property. Income is distinguished from an annuity. The income is considered the grantor's and is reportable by him; the obligor merely serves as a conduit.

V. Conclusion

The private annuity, as an estate planning tool, offers a medium for the lifetime transfer of property which decreases the transferor's taxable estate at death, yet assures him a yearly income until his death. If the transfer is made for adequate and full consideration, the transferor incurs no gift tax. If structured properly, the transferor-annuitant can defer the recognition of gain on the transfer of appreciated property. Three grounds for income tax deferral have been considered in this comment.

The first was the open transaction doctrine. The courts have been unanimous in holding that if the annuitant does not receive any security for the obligor's promise and if the obligor is an individual, the annuitant can defer the realization and recognition of gain until he has recovered his basis in the property transferred. However, Revenue Ruling 69-74 rejects this view, and the annuitant should consider carefully some of the language from *Estate of Lloyd G. Bell* and *212 Corp.* which also seems contrary to this view.

The second ground considered was the equivalent of cash doctrine. Traditionally, the courts have applied this test to determine whether a contract for deferred payments is an amount realized under section 1001 (b) to cash basis taxpayers. In a private annuity context, the obligor's promise to make further periodic payments, if unsecured, is not the equivalent of cash. It is uncertain whether even the secured promise of the obligor is the equivalent of cash. Thus, at first blush, the cash basis private annuitant can defer the realization of gain on the basis of the equivalent of cash doctrine. However, the courts do not seem willing to apply this doctrine to the private annuitant, Revenue Ruling 69-74 ignores the taxpayer's method of reporting income, and at least one court has rejected application of a cash equivalency test to section 1001 (b), applying instead a fair market value test.

The third ground considered was whether section 72 allows the annuitant to report ratably over his remaining life expectancy any gain

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which he is required to realize. Section 72 does not appear to be authority for such a proration approach; it treats only the reporting of income generated by the annuity contract itself. However, Revenue Ruling 69-74, the dissent in Estate of Lloyd G. Bell, and one dissent in 212 Corp. apply such an approach. In addition to those mentioned in this comment, other troubling tax questions exist for the private annuitant. They include, for example, the estate and gift tax consequences of a private annuity to the annuitant, as well as the obligor's side of the equation. Before an individual purchases a private annuity, these factors must be carefully considered and weighed to determine whether a private annuity would effect a desired transfer with a minimization of tax liability. Structured properly and utilized with discretion, the private annuity can be an effective tool for the estate planner.

Joseph C. Benage