

PRIVATE ANNUITY LEGAL PACKAGE, **ABBREVIATED**®

IRS Rulings Plus NAFEP

Research Material on The Legality of Private Annuities

And Private Annuity Trusts



The National Association of Financial and Estate Planning

This abbreviated NAFEP legal package focuses primarily on IRS rulings about private annuities generally and the technique of using private annuities with a trust. This technique is known as a private annuity trust or PAT, and we use the term PAT throughout this publication.

This publication is referred to as an “abbreviated” package, because NAFEP publishes a more comprehensive version, simply referred to as *Private Annuity Legal Package*.

The two Revenue Rulings which govern the taxation of private annuities are reprinted at this end of this package.

NAFEP NOTE: This is the IRS fundamental description of a private annuity trust, though the Ruling does not use that term. Nevertheless, this is one of the clearest and most straightforward explanations the IRS has given on the legality and effect of transferring assets to a trust in exchange for a life annuity. Also see the Private Letter Ruling immediately following this Ruling for further IRS clarification of the PAT concept.

Revenue Rulings

Rev. Rul. 77-454, 1977-2 CB 351, IRC Sec(s). 2512

Headnote:

Rev. Rul. 77-454, 1977-2 CB 351 – IRC Sec. 2512

Reference(s): Code Sec. 2512; Reg § 25.2512-8

Retained interest in depletable trust; valuation.

The present value of a life annuity payable from the assets transferred by the annuitant to an irrevocable trust that terminates upon his death with the property remaining payable to his heirs is based on annuity factors contained in section 25.2512-9(e) of the regulations, which take into account the annual payment until the death of the annuitant or until the fund is exhausted, whichever occurs first, and the gift in trust is the amount transferred to the trust less the value of the retained interest so computed.

Full Text:

Advice has been requested concerning the gift tax consequences of the conveyance of property to a trust under the circumstances described below.

On August 9, 1976, A executed an irrevocable deed of trust and transferred \$70,000 in cash to the trustee. Under the terms of the trust, the trustee is to pay A, out of trust assets, \$6,288.86 at the end of each year for the balance of A's life. The trust will terminate at the death of A, and the remaining trust property, if any, is payable to A's grandchildren. A, a male, was 51 years old on the nearest birthday to the date of the trust agreement.

Section 2512(b) of the Internal Revenue Code of 1954 provides that when property is transferred for less than an adequate and full consideration in money or money's worth, the amount by which the value of the property transferred exceeds the value of consideration received shall be deemed a gift for Federal gift tax purposes.

Section 25.2512-9(a)(1)(i) of the Gift Tax Regulations provides that when a donor transfers property in trust or otherwise and retains an interest therein, the value of the gift is the value of the property transferred less the value of the donor's retained interest. See also section 25.2511-1(e). Section 25.2512-9 of the regulations provides several tables for use in determining the present values of annuities, life estates, and remainders transferred after December 31, 1970. Table A(1) sets forth the present worth of \$1.00 payable in the form of an annuity, life estate, or remainder for the life of a male at each age listed therein, with an annual interest rate of six percent.

The present worth of an annuity of \$1.00 payable at the end of each year for the life of a male aged 51 years is \$11.1308, as set forth in Table A(1). (The above factor of \$11.1308, when multiplied by A's annuity of \$6,288.86, produces a present value of \$70,000, which is equal to the value of the **<Page 352>** property transferred by A to the trust.)

The annuity factors set forth in Table A(1) are based upon the assumption that payments can actually be received for each year even if the annuitant survives to age 109. If the annuity payments are to be drawn from a particular fund, however, an annuity factor from Table A(1) is applicable only if the fund is large enough to support the annuity in the event the annuitant lives to age 109. For example, an annuity payable only from a fund of \$200 cannot be

valued by using a factor from Table A(1) if an annuitant aged 51 years is to receive annual payments of \$100 for life. In such a situation, the annuitant's right to payments is not worth \$1,113 (the value produced through the use of a factor of \$11.1308 from Table A(1).) On the contrary, it is worth something less than \$200, due to the possibility that the annuitant may die before the fund is exhausted.

In the present case, \$70,000 in trust assets were available, at the date of the annuity agreement, for annual payments of \$6,288.86 to A for life. The annual payments will gradually exhaust the available fund because they are greater than the six percent interest that will presumably be earned by the fund each year. The fund will be sufficient to make the annual payment of \$6,288.86 for the first 18 years. At the end of the 19th year, the fund will only be able to make a payment of \$5,769.23. Therefore, in the present case, A has received the right to receive the annuity at the end of each year until death or until the fund is exhausted, whichever occurs first.

Valuation of the right to receive payment over a term of years or until the death of an individual, whichever occurs first, involves the use of a special factor which the Service will compute upon request in accordance with section 25.2512-9(e) of the regulations. The factor may also be computed through the use of Internal Revenue Service Publication 723A, entitled "Actuarial Values II, Factors at 6 Percent Involving One and Two Lives." Example 8, at page 1-3 of Publication 723A, sets forth the method for computing the value of an annuity payable for a stated period of years or until the prior death of a person of a particular age. In the present case, based on the method set forth in Example 8, the value of A's right to receive, if living, \$6,288.86 at the end of each year for 18 years, plus a final payment of \$5,769.23 at the end of the 19th year, is \$61,133.25.

Accordingly, since A transferred \$70,000 to the trust but retained an annuity interest in the trust worth \$61,133.25, the amount of A's gift in trust on the date of the agreement is \$8,866.75, which is the difference between the amount transferred by A that day (\$70,000) and the value of the retained amount (\$61,133.25).

NAFEP NOTE: In December, 2003, the IRS issued Private Letter Ruling 200352001, reprinted below, dealing with a private annuity trust transaction, or PAT. The situation did not merely involve a private annuity contract, but involved a private annuity contract *as issued by an irrevocable trust* in exchange for assets which the taxpayer would place in the trust. So the ruling involved a complete PAT transaction. And of special significance is that the transaction was structured essentially the same as a NAFEP created PAT.

The IRS accepted the annuity-trust part of the arrangement without comment, listing no problem or question with the PAT structure. The ruling did restate what a private annuity is, which included calculating the contract with IRS prescribed formulas, thus reinforcing the well known legality of private annuities generally. There is no doubt at all that the IRS would have noted their problems with the trust integration in the transaction had they perceived any, but none were noted. Instead, the IRS focused the ruling on whether or not the contract was a private annuity, vs. a certain kind of debt instrument known as an “original issued debt” (OID) instrument. The actual ruling stated, “we conclude that the private annuity obligation is excepted from the definition of debt instrument and the original issue discount provisions of section 1275”. Without finding OID problems with the structure, the ruling let the taxpayer’s PAT stand in every respect. This ruling continues the IRS position on private annuity trusts, as stated in Revenue Ruling 77-454 (reprinted immediately before this Ruling). These two rulings are a plus for PATs which are created in the manner which NAFEP does them, and amounts to a positive IRS “opinion letter” for PATs.

PRIVATE LETTER RULING 200352001, 12/24/2003, IRC SEC(S). 1275

Private Annuity Obligation—Debt Instrument.

Headnote:

Private annuity obligation resulting from taxpayer's transfer of partnership interest to trust is excepted from definition of debt instrument and original discount provisions of Code Sec. 1275.

Reference(s): Code Sec. 1275

Full Text:

Internal Revenue Service Department of the Treasury

Number: 200352001

Release Date: 12/26/2003 Washington, DC 20224

Date: September 10, 2003

Dear

This letter responds to your request, dated June 20, 2002, requesting rulings with respect to the transfer of certain property under the following circumstances.

Taxpayer is an individual aged a, who owns a real estate investment organization that provides a full range of services including acquisitions, planning, development leasing, property management and project management. Taxpayer proposes to transfer his interest in a partnership to the Trust in exchange for a private annuity that will provide fixed annual payments for his lifetime.

The Trust was established in Year 1, and the beneficiaries of the Trust are the grandchildren of Taxpayer. The Trust's assets consist of publicly traded stocks with a value of approximately b and real estate holdings with an approximate value of c. The Trust's only liability is a note payable in the amount of d.

The Partnership owns e% of the outstanding stock in the Company that owns interests in entities that own real estate. Taxpayer's Partnership Interest has a fair market value of f, and his basis in the Partnership Interest is g.

Pursuant to the Agreement, Taxpayer will irrevocably transfer his partnership interest to the Trust in exchange for the Trust's obligation to pay Taxpayer, upon 60 days demand, an annual annuity. The amount of the annuity payments will be calculated pursuant to applicable Internal Revenue Service and Tables to equal the value of the

Partnership Interest on the date of the transfer. Pursuant to the terms of the Agreement, the annuity payments from the Trust to the Taxpayer shall terminate and lapse with the last payment immediately preceding the Taxpayer's death or upon the death of the Taxpayer if no payments have been made prior to the Taxpayer's death. The Trust's obligation to make the annuity payments will not be secured by any assets owned by the Trust and the Trust will not establish any security or any fixed or other specific chargeable source for the payment of the annuity to Taxpayer. However, the Trustee is authorized to invade or dispose of Trust principal in order to meet the annuity obligations.

LAW AND ANALYSIS

An annuity is a periodic amount paid at a regular interval under an annuity contract which provides a determinable amount of payments in consideration for a fixed sum or a transfer of property. See, section 1.72-2 of the Income Tax Regulations. A private annuity is generally an arrangement whereby an individual or entity promises to make periodic payments to the transferor for the remaining life of the transferor.

Section 1275(a)(1)(B), in pertinent part, provides that the term debt instrument does not include any annuity contract to which section 72 applies which depends (in whole or in substantial part) of the life expectancy of one or more individuals. Section 1.1275-1(j)(2)(i) provides that for purposes of section 1275(a)(1)(B)(i) an annuity contract depends (in whole or in substantial part) on the life expectancy of one or more individuals only if (i) the contract provides for periodic distributions made not less frequently than annually for the life (or joint lives) of an individual (or a reasonable number of individuals); and (ii) the contract does not contain any terms or provisions that can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants).

Paragraphs (3) through (7) of section 1.1275-1(j) describe certain terms and conditions that can significantly reduce the probability that total distributions under the contract will increase commensurately with the longevity of the annuitant (or annuitants). Those terms and conditions are (1) the availability of a cash surrender option; (2) the availability of a loan secured by the contract; (3) a minimum payout provision; (4) a maximum payout provision; and (5) a decreasing payout provision.

In the instant case, the parties represent that at the time the Agreement becomes effective, it will be their intent that Taxpayer will receive annuity payments over his lifetime beginning on an agreed starting date within the period of the

Taxpayer's life expectancy determined under the applicable Tables. On the annuity starting date, the annuity payments will be made at least annually. The Agreement does not contain any terms that will significantly reduce the probability that the total annuity payments to the Taxpayer will increase commensurately with longevity.

CONCLUSION

Based upon the facts presented, and the representations of the Taxpayer, we conclude that the private annuity obligation is excepted from the definition of debt instrument and the original issue discount provisions of section 1275.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it.

Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Donald J. Drees

Senior Technician Reviewer, Branch 4

Office of Office of Associate Chief Counsel (Financial Institutions & Products)

NOTE: The following topics are NAFEP Research Material ©.

IRS Affirmation Of Private Annuities And Their Deferral

Treasury Decision TD-8754 affirmed the validity of private annuities and the deferral of private annuity payments. On February 9, 1998 the IRS and the Treasury Department issued final regulations for Code Section 1275(a)(1)(B)(i) and (ii), under decision TD-8754. Prior to this date the IRS and Treasury had published the regulations in a proposed form. These proposed regulations would have, if adopted, eliminated the ongoing practice of deferring private annuity contracts. However non-deferred private annuities would have continued to be legal. As announced in TD-8754, the IRS and the Treasury reversed their proposed deferral elimination position when they adopted the final regulations.

Sections 163(e) and 1271 thru 1275 of the federal tax code contain tax laws known as "original issue discount" rules. These rules relate to the tax treatment of debt instruments which have original issue discount. Section 1275(a)(1)(B)(i) exempts (private) annuity contracts from these rules if they meet certain parameters. Section 1275(a)(1)(B)(ii) exempts commercial annuities, those issued by an insurance company. Under TD-8754 (private) annuities were deemed to qualify for this exemption provided that they followed certain other rules (rules which NAFEP has always observed in the preparation of private annuity contracts). This left private annuity contracts to be regulated as they always were, primarily Section 72 of the code, Revenue Rulings 55-119 and 69-74, and GCM 39503 (see elsewhere in this package).

In addition to generally confirming the continued legality of private annuities, there was a very important side aspect of the regulations. This was the affirmation that private annuities may have their payment stream deferred. Quoting from TD-8754:

"After a careful review of this issue, the IRS and the Treasury have modified the regulations to eliminate the requirement that the annuity distributions begin within one year of the date of the initial investment in the contract."

"Several commentators expressed concerns that the proposed regulations, if finalized, would alter the tax treatment traditionally afforded private and charitable gift annuity contracts. Private annuity contracts are typically issued as consideration in intra-family transfers of property. In many cases, distributions under private and charitable gift annuity contracts are entirely contingent on the survival of one individual (or a small number of individuals). These contracts are

not indebtedness under general principles of federal income tax law and, therefore, are not within the definition of debt instrument in section 1275(a)(1)(A). For almost all other private and charitable gift annuities, the final regulations address the concern by removing the requirement that the distributions begin within one year of the date of the initial investment in the contract."

The final regulations do address several concerns that the IRS and the Treasury had regarding whether a private annuity is based on sound annuity factors and actuarials. If the annuity deviates from being a real annuity it will be treated as a debt instrument with original issue discount and taxed accordingly. The rules that the final regulations lay down prevent private annuities from having the following provisions:

1. Cash surrender options.
2. Loans to the annuitant which are secured by the private annuity contract itself (though presumably loans which are adequately secured by other property and which are made at market interest rates are legal).
3. Minimum payouts.
4. Maximum payouts.
5. Decreasing payouts.
6. Any other provision that can significantly reduce the probability that sound life time annuity factors and actuarials are followed. (The actual language used in TD-8754 is "any other term or provision that can significantly reduce the probability that total distributions under the contract will increase commensurately with longevity".)

NAFEP private annuity contracts have never included these prohibited provisions and should continue to qualify for private annuity treatment, either with or without deferral of the annuity payment stream.

Excerpts And Review Of IRS Memo GCM 39503 of 5/19/86

NAFEP NOTE: The IRS' GCM 39503 concerns whether a certain transaction under review should be treated as an installment sale or private annuity. The effect in distinguishing between private annuities and installment sales is far reaching because a properly structured private annuity has significant tax advantages over an installment sale. Further, this IRS Memo makes it clear that private annuities escape estate taxes. The following are key excerpts from this GCM:

Distinction Between Installment Sale and Private Annuity.

"We believe that when property is transferred in exchange for a transferee's promise to make periodic payments to the transferor until his death, the transaction should be considered a private annuity....If the stated monetary amount would be received by the transferor before the expiration of his or her life expectancy (as determined actuarially at the time of the sale agreement), then the transaction will be characterized as an installment sale."

"This brings us to the question of whether the installment sales rules of section 453 of the Code or the annuity rules of section 72 govern the treatment of periodic payments received by a taxpayer....We believe that where the conveyer of property receives a right to periodic payments for the remainder of his life, with no monetary limit provided...the payments represent an annuity and should be governed by section 72. A stream of payments for life is squarely within the accepted concept of an annuity in our opinion, so the annuity rules in the Code, at section 72, are logically applicable. The Service already appears to have so recognized in Rev. Rul 69-74, 1969-1 CB 43, which applies section 72 where appreciated property is exchanged for a right to periodic payments for life."

Legal to Use Private Annuity for Estate Tax Planning

"Private annuity arrangements are often used for intra-family transfers whereby an older family member transfers appreciated property to a younger family member in order to gain tax advantages, e.g., removal of the property from the transferor's gross estate." "A private annuity also should not be included in the transferor's gross estate for Federal estate tax purposes. "

"Related Party" Rules Are Inapplicable, Quick Sale Is Legal

"The related party resale rules outlined above are inapplicable to private annuity transactions. Thus the transferee in a private annuity situation could quickly dispose of the property, and no accelerated recognition of gain would be charged to the original seller/transferor."

Section 72 plus Revenue Rulings 55-119 and 69-74 Control Private Annuities

"The Service already appears to have so recognized in Rev. Rul 69-74, 1969-1 CB 43, which applies section 72 where appreciated property is exchanged for a right to periodic payments for life" "The income tax treatment afforded unsecured private annuity payments is set forth in Revenue Ruling 69-74...which applies the provisions of section 72 to private annuity transactions." "Rev. Rul. 55-119, 1955-1 CB 352, prescribes the method for calculating a taxpayer's basis in property received in exchange for a private annuity."

Is It Legal For Trusts To Issue Private Annuity Contracts?

Note: For clarification purposes, the private annuity/trust arrangement which is discussed below, and in this whole document package, is referred to as a "PAT" (private annuity trust).

Throughout the history of the use of the private annuity they often have been issued by a family trust. If a trust or other legal entity isn't used to issue the contract, the annuitant must enter into the arrangement directly with individuals, usually children or other heirs. When property owners are planning a private annuity transaction it is desirable for them to use a trust to issue the annuity for several reasons:

1. The annuitant's children or other heirs may be underage and not legally able to enter into the transaction.
2. The annuitant's children or other heirs may not be skilled or trustworthy enough to manage the assets exchanged for the annuity, especially when the assets are liquidated.
3. For privacy reasons, the annuitant may not wish to involve his children or other heirs directly in the transaction.
4. The children or other heirs may get into legal difficulties, such as lawsuits, tax liens or divorces, which would result in the annuity

assets being attached in a resulting legal action. Without an intermediary entity (such as a trust) to hold the assets, the individual's legal difficulties can directly attach to the assets.

5. The trust provides a formal, written and legal arrangement to administer the private annuity transaction, so there will be no questions or misunderstandings on what and how things are to happen. Much greater control is effected.

There definitely are court cases where private annuity (PAT) transactions in a trust have been disallowed, with *Lazarus v. Commissioner*, 58 TC 854, 8/17/1972, being the most often cited example. Some practitioners, without looking beyond this and/or a couple of other cases, then go so far as to say that the IRS does not allow the use of a trust with a private annuity. However, more thorough research reveals that the mere incorporation of a trust into the private annuity transaction does not make the transaction any more prone to IRS disallowance when the structure is created and operated correctly. The IRS can and will challenge any defective or illegal structure, whether it is a trust, corporation, pension plan or whatever. A private annuity utilizing a trust (PAT) is no more and no less vulnerable than other, mainstream tax planning.

In some cases the IRS, upheld by the Tax Court, has disallowed the trust and the private annuity (PAT) transaction. This was usually done by declaring the trust to be a sham, to be non-existent for tax purposes. But the reasons that the Tax Court disallowed the PAT arrangement were due to the trust being handled either or both in a defective or fraudulent manner. In one important case where the Tax Court disallowed a properly structured trust, the decision was reversed on appeal to Ninth Circuit Court. In several other cases, trusts were specifically allowed to issue the private annuity where the trust was properly structured and operated (see "Legal Cites" below).

Legal Cites for PATs.

1. Treasury Regulation § 1.72-2(a)(1), "For the purposes of Section 72, however, it is immaterial whether such contracts (life insurance, endowments and annuities) are entered into with an insurance company". The Treasury Regs have left the issuance of annuity contracts unlimited to any specific entity. For example, a type of private annuity is issued by charities and religious organizations (charitable gift annuities), and other types of private annuities are issued by

charitable remainder trusts (CRT), grantor retained annuity trusts (GRAT) and grantor retained unitrusts (GRUT). From the other material in this information package, it is clear that this Section 72 quoted above includes the PAT type private annuity under its regulatory control.

2. Treasury Regulation § 25.7520-3, and the several examples which accompany this section, is totally devoted to explaining certain life expectancy rules which apply when private trusts issue (private) annuities. This section imposes a special life expectancy when a trust or other limited source of funds issues an annuity, if the annuity is based on an interest rate which is greater than the AFMR (applicable federal mid-term rate). So this whole Treasury Regulation Section and its accompanying examples was written with the specific expectation that private trusts would issue private annuities. These private annuities include the PAT variety which is the subject of this legal package, but also include CRTs, GRATs and GRUTs, all of which are private annuities issued by private trusts, and all must use the same annuity factors, life expectancy table, AFMR interest rate and certain other factors and formulas.
3. Revenue Ruling 77-454 approved the use of a trust in a private annuity (PAT) transaction without any restrictions beyond the proper valuation and calculation issues and the treatment of an undervalued amount as a gift (standard procedure).
4. *LaFargue v Commissioner*, 689 F.2d 845 (1982). This is arguably the most important legal precedent for the ability of trusts to issue a private annuity (PAT variety) in exchange for property, and for understanding what is legal and what isn't (see the below list of eight, NAFEP developed rules). In this case, the Ninth Circuit U.S. Court of Appeals reversed a Tax Court decision, 73 T.C. 40, where the Tax Court had disallowed a private annuity transaction using a trust, even though the trust appeared to be properly structured. Any doubt about the legal ability of a PAT type trust to be a party to the private annuity transaction should be removed upon reviewing this case.
5. *Benson v. Commissioner*, 80 TC 789. This is the same Tax Court that heard and held against *LaFargue*, above, and were then reversed. Here, the Tax Court was faced with exceptionally similar facts as in *LaFargue*. The Tax Court upheld the PAT this time,

stating, “the similarities (to LaFargue) are striking and we believe we should not again elevate substance over form. We therefore hold...that the payments received by (the annuitant) were bona fide annuity payments.

6. Sidney B. Stern, TC Memo 1992-374. This important case reflects both a Ninth Circuit Court of Appeals and a Tax Court decision to allow a private annuity trust (PAT) transaction to stand, even though there were some questionable provisions allowed to the annuitants in the trust structure.
7. Weigl v. Commissioner, 84 TC 1192 (1985). In this Tax Court Case, the private annuity/trust transaction was held to be invalid because the annuitant retained “effective control”. But this case outlined six rules for determining whether a private annuity trust was independent of the grantor, or whether the trust was grantor owned. The Tax Court cited Stern and LaFargue (listed above) as part of the basis for the rules. Following these six rules, as all NAFEP PATs are designed to do, makes the trust legal for private annuity purposes (an independent entity). Even though the PAT in this case was illegal, it was made clear what would constitute a legal PAT.

Comparison With Other Annuity Trusts. In regards to Treasury Regulation § 25.7520-3, referred to in Legal Cite Number 2 above, an

important correlation to PATs is revealed. In addition to PATs, § 25.7520-3 also regulates charitable remainder trusts (CRT), grantor retained annuity trusts (GRAT) and grantor retained unitrusts (GRUT). CRTs, GRATs and GRUTs are other examples of private trusts issuing private annuities. The private annuities from these three other trusts may use different terms of duration and payment schemes than PATs do, but all the same they are just variations of a private annuity. CRTs, GRATs and GRUTs all use trusts to issue their variation of private annuities, there is no other way for them to work. These other three annuity trust types are well known, mainstream planning vehicles. They are readily acceptable to the IRS and supported by tax laws and regulations. The private annuities which these trusts issue are taxed a little differently than the standard PAT type private annuity (in some cases the differences are very minor). Nevertheless, the effect, structure, operation and usage of CRTs particularly is virtually indistinguishable from PATs. CRTs, GRATs and GRUTs are subject to many of the same annuity calculation factors (life expectancy table, AFMR interest rate, annuity factors, and certain other factors and formulas). It makes no sense to argue that a PAT cannot issue a private annuity when that is the only IRS accepted mode of operation for CRTs, GRATs and GRUTs, and when much of their governing law is the same.



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NAFEP NOTE: This is the first of two important Revenue Rulings from the IRS which explain taxation methodology of private annuities. Immediately following this Ruling is the second one. That these two Rulings remain current and applicable was affirmed in the IRS GCM-39503 (see page 6 of this publication for a quote).

Rev. Rul. 55-119, 1955-1 CB 352

Headnote: Basis for computing the depreciation allowance and for determining gain or loss upon the disposition of property acquired in exchange for an annuity contract.

O. D. 945, C. B. 4, 44 (1921), and S. M. 3141A, C. B. IV-2, 183 (1925), modified.

Full Text:

Advice has been requested relative to the basis for (1) computing depreciation and (2) determining gain or loss upon the subsequent sale or exchange of property received by a taxpayer in exchange for an agreement to make annuity payments to the annuitant (transferor of the property) for the remainder of the annuitant's life.

In O. D. 945, C. B. 4, 44 (1921), the taxpayer received certain land in exchange for a cash payment and his promise to support his mother for the remainder of her life. O. D. 945, as modified by I. T. 2689, C. B. XII-1, 160 (1933), pursuant to the recommendation to that effect in G. C. M. 11655, C. B. XII-1, 159 (1933), holds that the basis for determining gain or loss on the sale of such land is the sum of the cash payment plus the discounted value of the support to be furnished. In S. M. 3141A, C. B. IV-2, 183 (1925), the taxpayer purchased her mother's life interest in property, giving as the consideration therefore her agreement to contribute to the support of her mother for the remainder of her mother's life. S. M. 3141A holds that the total of the payments made and to be made by the taxpayer under the contract will represent the cost of the property acquired.

Under the provisions of section 23(e) of the Internal Revenue Code of 1939, one of the requisites of a deductible loss is that such loss must actually be sustained during the taxable period for which the deduction therefore is sought and evidenced by a closed and completed transaction. See section 39.23(e)-1 of Regulations 118. A transaction in which a taxpayer who is not engaged in the business of writing annuity contracts receives property in exchange for his promise to make annuity payments to the transferor is not a closed and completed transaction until the death of the annuitant. It is not until the death of the annuitant that the fixed cost of the property so acquired may be determined. The annuitant having died and payments under the contract having terminated, the cost of the property, for Federal income tax purposes, is the total of the annuity payments made. See *Thomas H. Mastin v. Commissioner*, 28 Fed. (2d) 748; *Citizens National Bank of Kirksville, Mo. v. Commissioner*, 122 Fed. (2d) 1011, certiorari denied, 315 U. S. 822; and *D. Bruce Forrester v. Commissioner*, 4 T. C. 907. Of course, if the property acquired in exchange for an annuity contract is depreciable property, or if the property is sold prior to termination of the annuity payments, it is necessary to determine a basis upon which to compute a reasonable allowance for depreciation and upon which the gain or loss from the sale or exchange of the property may be determined.

In view of the foregoing and assuming an arm's-length transaction with no intent of a gift on the part of either party, where a taxpayer who is not engaged in the business of writing annuities receives property in exchange for his contract to make annuity payments, the following Federal income tax consequences will result, subject, however, to the provisions of section 24(b) of the Code of 1939, relating to the nondeductibility of certain losses from sales or exchanges of property:

1. The basis (unadjusted)¹ of the property for the purpose of computing the allowance for depreciation prior to the death of the annuitant shall be the value of the prospective payments under the annuity contract (computed as of the date of the transaction in accordance with Table I, section 86.19(f) of Regulations 108 with reference to the life expectancy of the annuitant) until such time as the annuity payments equal the value of the annuity contract at the date of the transaction. Any annuity payments made in excess of the value of the annuity contract at the date of the transaction should be added to the basis of the property for depreciation purposes. However, upon the death of the annuitant, the basis (unadjusted) for computing any subsequent allowance for depreciation becomes the total of the


annuity payments made under the contract. In the event depreciable and nondepreciable property is received, an allocation, for the purpose of computing the basis for the depreciable portion of the property, must be made on the basis of the ratio of the respective fair market values of the depreciable and nondepreciable properties at the time acquired.

2. Should disposition of the property occur after the death of the annuitant, the basis (unadjusted) for determining gain or loss shall be the total of the annuity payments made under the contract. See *D. Bruce Forrester v. Commissioner, supra*.

3. Should disposition of the property occur prior to the death of the annuitant, the basis (unadjusted) for determining gain shall be the total of the annuity payments made under the contract up to the date of disposition plus the value of the prospective payments remaining to be paid at the date of such disposition (computed in accordance with Table I, section 86.19(f) of Regulations 108 with reference to the life expectancy of the annuitant as of the date of disposition of the property). The basis (unadjusted) for determining loss shall be the total of the annuity payments actually made at the time of disposition. Compare section 39.23(e)-1, Regulations 118; *Thomas H. Mastin v. Commissioner, supra*, and *Citizens National Bank of Kirksville, Mo. v. Commissioner, supra*. Of course, a situation may arise where the selling price is less than the adjusted basis for gain and greater than the adjusted basis for loss. In such a case, neither gain nor loss would be recognized at the time of the sale.

Where disposition of property acquired in exchange for a promise to make annuity payments has occurred prior to the death of the annuitant, the taxpayer may realize a gain or loss, for Federal income tax purposes, as a result of events occurring subsequent to such disposition. Whether such events result in a recognized gain or a recognized loss is dependent upon the circumstances in each individual case. If the total of the annuity payments made under the contract (total of payments made before and after disposition of the property) exceeds the basis (unadjusted) of the property used in determining the gain or loss on the disposition, such excess is a loss in the year or years in which paid. In the case of a recognized loss, this will include all payments made after the date of disposition of the property. Where the selling price is such that neither gain nor loss is recognized upon disposition of the property, no loss is sustained until the total of the payments made under the annuity contract (total of payments made before and after disposition of the property) when decreased by depreciation allowed or allowable exceeds the selling price, at which time such excess is a loss in the year in which paid.

On the other hand, in the case of a recognized gain upon disposition of the property prior to the death of the annuitant, if the total of the annuity payments ultimately made is less than the basis (unadjusted) for computing such gain, the excess of such basis over the total of the annuity payments will constitute income in the year the annuitant dies. In the case of a recognized loss, there will be no gain as a result of the annuitant's death. In case neither gain nor loss was recognized upon the disposition of the property, if the total annuity payments ultimately made (decreased by depreciation allowed or allowable during the period the property was held and adjusted for capital additions or subtractions) is less than the selling price, the excess of the selling price constitutes income in the year the annuitant dies.

The nature of any gain or loss, whether capital or ordinary, which is recognized as a result of events occurring subsequent to the sale of the property involved will depend upon the purpose for which the property was held. Compare *F. Donald Arrowsmith et al., executors of the last will and testament of Frederick R. Bauer, deceased, and Ruth R. Bauer et al. v. Commissioner*,  344 U. S. 6, Ct. D. 1752, C. B. 1952-2, 136.

The principles outlined above may be illustrated by the following examples:

(a) Assume the fair market value of the property received is \$95,000 (land \$15,000 and building \$80,000) and the property is used in the taxpayer's trade or business or for the production of income. The remaining life of the building is 50 years and the estimated salvage value of the building at the end of that time is \$15,000. The annuity contract provides for annual payments of \$10,000 to the annuitant (transferor) for the remainder of his life. At the time of transaction the present value of the annuity contract is \$94,785 (at age 69).

The annual depreciation would be computed for the period up to the date of the annuitant's death as follows: \$80,000 -----X\$94,785 - \$15,000 \$95,000 -----=\$1,296.38 50

(b) If the annuitant should die at the end of the eighth year, the annual depreciation for subsequent taxable years would be computed as follows: \$80,000 -----X\$80,000(2)-\$15,000-\$10,371.04(3) \$95,000 -----
-----=\$999.94 42 (remaining life of building) (2)Eight annuity payments made. (3)Depreciation for 8 years at \$1,296.38.

(c) Assuming the property was sold at the end of the ninth year and prior to the death of the annuitant, the recognized gain is computed as follows:

Selling price \$150,000.00

Basis:

Annuity payments made (9x\$10,000) \$90,000.00

Plus: Value of prospective payments

at date of sale (age 78) 63,705.00

Unadjusted basis \$153,705.00

Less: Depreciation (9x\$1,296.38) 11,667.42

Adjusted basis 142,037.58

Recognized gain \$7,962.42

Losses from annuity payment made after the property is disposed of would be recognized after the aggregate of the annuity payments exceeds \$153,705, *i. e.*, \$6,295 of the 16th annual payment and all subsequent payments are losses in the year in which paid. However, if the 15th annual payment was the final payment made, there would be a recognized gain of \$3,705 (\$153,705 minus \$150,000).

(d) Assuming all facts the same as in the preceding example, except that the selling price is \$75,000, the recognized loss is computed as follows:

Selling price \$75,000.00

Unadjusted basis (9 annuity payments made) \$90,000.00

Less: Depreciation (9 x \$1,296.38) 11,667.42

Adjusted basis 78,332.58

Recognized loss \$3,332.58

In this instance, each annuity payment made after the sale of the property would be recognized as a loss in the year paid.

(e) If the selling price were \$105,000.00, no gain or loss would be recognized at the time the property is disposed of, since the selling price falls between the basis (adjusted), \$142,037.58, for computing a recognized gain and the basis (adjusted), \$78,332.58, for computing a recognized loss. In this situation, there would be a recognized loss of \$3,332.58 on the 12th annuity payment (selling price, \$105,000-(total payments, \$120,000-- depreciation, \$11,667.42). The full amount of each succeeding payment would be a recognized loss in the year paid. If, however, the annuitant died after only 11 payments had been made, there would be a recognized gain in the year of the

annuitant's death in the amount of \$6,667.42 (selling price, \$105,000- -(total payments, \$110,000--depreciation, \$11,667.42)).

If, in fact, an element of gift is involved in connection with a transaction where property is acquired in exchange for an annuity contract, such fact must be considered by the recipient of the property in determining his basis for computing the depreciation allowance and for determining gain or loss upon subsequent disposition of such property. Under section 113(a)(2) of the Code the donee's basis for determining gain on the disposition of property received as a gift is the same as it would be in the hands of the donor, or the last preceding owner by whom it was not acquired by gift; the donee's basis for determining loss is the same as the basis for determining gain, or the fair market value of the property at the time of the gift, whichever is lower. The basis for depreciation is the same as the basis for computing gain. Section 114(a) of the Code. Thus, in determining the basis for gain, loss or depreciation the donee's basis of the portion of the property acquired by gift should be added to the basis computed under each of the above-stated rules relating to property received in exchange for an annuity contract only. In determining the basis for gain, loss or depreciation which is attributable to the portion of the property transferred as a gift, the donor's basis or the fair market value of the total property transferred, as the case may be, is reduced by the value of the prospective annuity payments to be made (computed as of the date of the transaction in accordance with Table I, section 86.19(f) of Regulations 108 with reference to the life expectancy of the annuitant). Where necessary, an allocation of the basis of the portion of the property received as a gift should be made between depreciable and nondepreciable property based on the ratio of the total fair market values of such depreciable and nondepreciable property.

See Revenue Ruling 239, C. B. 1953-2, 53, as to the taxability of annuity payments received by an annuitant who has transferred real property in exchange for an annuity contract.

To the extent they are inconsistent with the foregoing, S. M. 3141A, C. B. IV-2, 183 (1925), is modified, and O. D. 945, C.B. 4, 44 (1921), as modified by I. T. 2689, C. B. XII-1, 160 (1933), is further modified.

¹ When used in this ruling, the term "basis (unadjusted)" refers to the basis prior to the adjustment for depreciation, and does not contemplate capital additions or subtractions.

NAFEP NOTE: This is the second of two important Revenue Rulings from the IRS which explain taxation methodology of private annuities. Immediately preceding this Ruling is the first one. That these two Rulings remain current and applicable was affirmed in the IRS GCM-39503 (see page 6 of this publication for a quote).

Rev. Rul. 69-74, 1969-1 CB 43, IRC Sec(s). 72

Headnote: Principles to be applied in determining the tax consequences of the transfer of appreciated property for a private annuity contract in an intra- family exchange.

Full Text:

Advice has been requested relative to the treatment for Federal income and gift tax purposes of monthly payments received under the circumstances outlined below.

In the instant case, the taxpayer, age 74, transferred property (a capital asset) having an adjusted basis of \$20,000, and a fair market value of \$60,000, to his son in 1966, in exchange for the legally enforceable promise of the latter to pay him a life annuity of \$7,200 per annum payable in equal monthly installments of \$600.

Section 72(b) of the Internal Revenue Code of 1954 provides that gross income does not include that part of any amount received as an annuity which bears the same ratio to such amount as the investment in the contract bears to the expected return under the contract. Further, section 1.72-3 of the Income Tax Regulations states that amounts received under annuity contracts are not to be included in the income of the recipient to the extent that such amounts are excludable from gross income as the result of the application of section 72 of the 1954 Code and the regulations thereunder.

Accordingly, the tax consequences of the private annuity transaction in this case are determined by applying the following principles:

(1) The gain realized on the transaction is determined by comparing the transferor's basis in the property with the present value of the annuity. Section 1.101-2(e)(1)(iii)(b)(3) of the regulations prescribes the appropriate table to be used for valuing a private annuity contract. (U.S. Life Table 38 contained in paragraph (f) of section 20.2031-7 of the Estate Tax Regulations.) The gain realized will be capital gain if the transferred property constitutes a capital asset.

(2) The excess of the fair market value of the property transferred over the present value of the annuity acquired constitutes a gift for Federal gift tax purposes where the transaction is not an ordinary business transaction within the meaning of sections 25.2511-1(g)(1) and 25.2512-8 of the Gift Tax Regulations.

(3) The gain should be reported ratably over the period of years measured by the annuitant's life expectancy and only from that portion of the annual proceeds which is 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.

(4) The investment in the contract for purposes of section 72 of the 1954 Code is the transferor's basis in the property transferred. 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. Applying the foregoing principles, the transaction in the instant case is taxable as follows:

(1) Based on U.S. Life Table 38, with interest at 3 1/2 percent, the present value of the right of a person age 74 to receive a life annuity of \$7,200 per annum is \$47,713.08.

(2) The excess of the fair market value of the property transferred over the value of the annuity received as a gift to the son from the father. (\$60,000 minus \$47,713.08 is \$12,286.92, the gift made by the father to his son.)

(3) The basis of the property is \$20,000.

(4) The excess of the value of the annuity received over the basis in the property transferred represents the gain realized. (\$47,713.08 minus \$20,000 is \$27,713.08 the gain realized.) See section 1.1001-1(e)(1) of the Income Tax Regulations.

(5) The computation and application of the exclusion ratio, the gain, and the ordinary annuity income is as follows:

\$72,720 expected return (annual proceeds multiplied by 10.1, the life expectancy).

\$20,000 (investment in the contract) divided by \$72,720 (expected return) equals exclusion ratio of 27.5 percent.

(a) Annual proceeds, \$7,200.

(b) Exclusion (27.5 percent of \$7,200), \$1,980.

(c) Capital gain income (\$27,713.08) divided by 10.1 years (the life expectancy), \$2,743.87.

(d) Ordinary annuity income: (a), minus the total of (b) plus (c), \$2,476.13.

The exclusion ratio of 27.5 percent is applicable throughout the life of the contract. After the capital gain of \$27,713.08 has been fully reported, subsequent amounts received (after applying the exclusion ratio) are to be reported as ordinary income.

Revenue Ruling 239, C.B. 1953-2, 53, which was issued under different provisions of prior law, is not determinative under section 72(b) of the Code.