Tax Planning for the Not-So-Rich: Variable and Private Annuities

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TAX PLANNING FOR THE NOT-SO-RICH. VARIABLE AND PRIVATE ANNUITIES

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INTRODUCTION:

The Inflation—Tax Whipsaw

Inflation and Taxes

After a lifetime of hard work and saving for retirement many persons have discovered when retirement arrives that they do not have enough income in the last years of their lives. Usually capital has been placed in fixed income investments which, while "safe," are acutely unattractive in an inflationary economy. As the dollar shrinks so does one's nestegg. The dilemma is to assure a stable retirement income while guaranteeing a true hedge against inflation.

This problem exists for others besides the pensioner. The youthful executive with every expectation of a spiraling income wants the deferred portion of his compensation to be economically meaningful in


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later years. Anyone selling property on an installment basis must anticipate a diminution in the dollar values of prospective payments. How may one achieve retirement security and a continuation of real and constant purchasing power over the years?

The purchasing power of the dollar had diminished by 1968 to only forty per cent of its 1939 value. To aggravate this diminution in dollar values, actual gross average weekly earnings had increased by 1968 to about five times their 1940 base, thereby imposing a further pinch upon a fixed income interest received during the earlier years of this period. During the same period the increase in the average value of common stocks was dramatic. The Dow Jones Industrial average ascended from 150 points in 1939 to over 900 in recent months. As a result, fixed income interests have become less and less attractive, while equity investments, including mutual funds, have become more and more so. To meet competition for investment dollars, insurers have glamorized the traditional fixed income agreement, the annuity, by initiating programs under which an annuitant’s payments during the accumulation period are invested not in fixed income properties such as corporate and Treasury bonds and real property mortgages, but in a portfolio of common stocks. The arrangement is quite similar to investing in a mutual fund.

2. Gross average weekly earnings were $23.86 in 1939, BUREAU OF THE CENSUS, U.S. DEPT OF COMMERCE, No. 240, STATISTICAL ABSTRACT OF THE UNITED STATES 203 (1950); in 1968 they were $120.18. Id. No. 331, at 230 (1968).
3. TRADERS RESEARCH, INC., DOW JONES CLOSING STOCK AVERAGES, 1897 TO DATE, 1939 chart (1959); The Wall Street Journal, June 11, 1969, at 1, col. 2. At the date of this writing, October 21, 1969, the average had declined to 846.88. On February 9, 1966 the average closed at its all time high of 995.15.
4. "From 1946 to 1966, the life-insurance industry’s share of American savings nose-dived from 51 per cent to about 16 per cent. During the same period, sales of mutual funds—companies that sell shares to the public and invest the proceeds in stock portfolios—have multiplied 14 times.” The National Observer, supra note 1, at col. 4.
5. This ability of a well-managed, diversified portfolio of common stocks to increase more than, or at least to keep pace with, the rise in the cost of living may be illustrated by the following tables, comparing the years between December 1939 and December 1967.

Inflation has not been alone in squeezing the dollar. At the same time that dollar values were decreasing to forty percent of their 1939 base, federal individual income tax rates rose from a 1939 average rate for those in the $10,000 to $25,000 tax bracket of 6.5 percent\(^7\) to an average rate between 1965 and 1968 of 17.4 percent for a single person with no dependents in the $10,000 bracket or an average rate of 27.9 percent for the same single person with no dependents in the $25,000 bracket.\(^8\) State and local income taxes also mushroomed from

\[\begin{array}{c|c|c|c|c|c}
\hline
\text{Year} & \text{1939} & \text{1947} & \text{1957} & \text{1967} & \text{1977} \\
\hline
1939 & 12.37 & 14.97 & 16.16 & 17.48 & 20.49 \\
1947 & 29.54 & 23.48 & 21.29 & 18.16 & 14.97 \\
\hline
\end{array}\]

6. The relationship is analogous in several respects. In neither the variable annuity nor the mutual fund contract does the purchaser make any individual decisions with respect to particular investments. In both cases also, the value of his investment will depend upon the decision-making ability of management with respect to the portfolio.


8. \textit{Id.} No. 552 at 388 (1968). This disparity is not quite as great for married persons filing a joint return or for persons filing under the "head of the household" provision. \textit{Int. Rev. Code of 1954}, §§ 1(b), 2; \textit{e.g.}, for the former, the average rate of tax for a married couple, no dependents, with an income of $10,000 was 13.4%; for a married couple, no dependents, with an income of $25,000, the average rate of tax was 19.2%. \textit{Bureau of the Census}, U.S. Dep't of Commerce, No. 552, Statistical Abstract of the United States 388 (1968). The average rate of tax for the head of a household would be somewhat higher.
a low of sixty three dollars per capita in 1942 to two hundred and ninety dollars per capita in 1966.9

In the interest of minimizing, but not "avoiding," taxes, myriad arrangements, too numerous and well known to the tax bar to discuss here, have been tried. One of these is the inter vivos trust. Another, not rising to the formality of a trust, has been the private annuity. The private annuity has been extremely valuable in tax planning. A Revenue Ruling issued in February10 of this year makes it less attractive from an income tax savings standpoint, but it is not likely that the private annuity will fall into disuse now, as it continues to offer the opportunity to defer income recognition upon the transfer of appreciated property and to afford estate and gift tax benefits as well.11

While either a trust or a private annuity may be used by the wealthy, the private annuity, especially, lends itself to use by one of more moderate means. He may have a single valuable income-producing asset which he wants to retain within the family group with minimum reduction through tax liabilities. He can transfer this property to another in return for a promise to pay him an income for life or for a fixed period, which may not be formally, but is realistically, satisfied out of the transferred property. The private annuity also has the potential of reducing the annuitant's taxable income, and thus increasing his net after-tax dollars by averaging the income from the property over several years rather than concentrating it into a short period. At the same time, the property may be retained within the family group, but the transferor may avoid or become exposed to a reduced gift tax liability, as well as eliminate federal estate and state inheritance taxes on the property.12 Additionally, if the property is depreciable, as it usually is, the transferee will receive the benefit of a high basis for depreciation at very little initial investment,13 and while at the same time the annuitant may have exhausted his depreciation deductions.

In the gift-estate tax relation, the private annuity is suited to assisting the broadest range of taxpayers. Federal gift tax rates are less than

12. Id.
those of the estate tax.\textsuperscript{14} It is easier for a wealthy person with other capital from which to satisfy his financial needs to dispose of property during life, thereby taking advantage of the lower gift tax rates as well as the annual gift tax exclusions and lifetime gift tax exemption.\textsuperscript{15} Ordinarily, the person of more moderate means must retain his income-producing property to have adequate resources to live out his days, and then transfer his capital at death. The private annuity, which may or may not have a gift element, allows him to make the living transfer,


**ESTATE AND GIFT TAXES**

Tax base for estate tax—Taxable estate of U. S. citizens and residents after deducting $60,000 exemption. Tax is at rates below, less credit under "State Death Tax Credit" Table or less state taxes, whichever is smaller. Estates of nonresident aliens dying after November 13, 1966 are taxed under a separate rate schedule. See Code Secs. 2101 and 2106.

Tax base for gift tax—Net gifts, after $30,000 exemption and annual exclusion for donees —$5,000 through '38, $4,000 for '39-'42, $3,000 after '42.

\begin{center}
\begin{tabular}{|c|c|c|c|c|}
\hline
Tax Base & Estate Tax & \% On & Gift Tax & \% On \\
Over & \$ & $ & Over & \$
\hline
$0 & $0 & 0 & $0 & 0 \\
5,000 & 150 & 7 & 112.50 & 5\frac{1}{4}
\hline
10,000 & 500 & 11 & 375 & 8\frac{1}{4}
\hline
20,000 & 1,600 & 14 & 1,200 & 10\frac{1}{2}
\hline
30,000 & 3,000 & 18 & 2,250 & 13\frac{1}{2}
\hline
40,000 & 4,800 & 22 & 3,600 & 16\frac{1}{2}
\hline
50,000 & 7,000 & 25 & 5,250 & 18\frac{1}{4}
\hline
60,000 & 9,500 & 28 & 7,125 & 21
\hline
100,000 & 20,700 & 30 & 15,525 & 22\frac{1}{2}
\hline
250,000 & 65,700 & 32 & 49,275 & 24
\hline
500,000 & 145,700 & 35 & 109,275 & 26\frac{1}{2}
\hline
750,000 & 233,200 & 37 & 174,900 & 27\frac{3}{4}
\hline
1,000,000 & 325,700 & 39 & 244,275 & 29\frac{3}{4}
\hline
1,250,000 & 423,200 & 42 & 317,400 & 31\frac{1}{2}
\hline
1,500,000 & 528,200 & 45 & 396,150 & 33\frac{3}{4}
\hline
2,000,000 & 753,200 & 49 & 564,900 & 36\frac{3}{4}
\hline
2,500,000 & 998,200 & 53 & 748,650 & 39\frac{3}{4}
\hline
3,000,000 & 1,263,200 & 56 & 947,400 & 42
\hline
3,500,000 & 1,543,200 & 59 & 1,157,400 & 44\frac{3}{4}
\hline
4,000,000 & 1,838,200 & 63 & 1,378,650 & 47\frac{3}{4}
\hline
5,000,000 & 2,468,200 & 67 & 1,851,150 & 50\frac{3}{4}
\hline
6,000,000 & 3,138,200 & 70 & 2,353,650 & 52\frac{3}{4}
\hline
7,000,000 & 3,838,200 & 73 & 2,878,650 & 54\frac{3}{4}
\hline
8,000,000 & 4,568,200 & 76 & 3,426,150 & 57
\hline
10,000,000 & 6,088,200 & 77 & 4,566,150 & 57\frac{3}{4}
\hline
\end{tabular}
\end{center}

\textsuperscript{15} Int. Rev. Code of 1954, §§ 2503(b), 2521.
thereby reducing his taxable estate, but at the same time gain the promise of income for life.\textsuperscript{16}

As winter follows spring, the private annuity is not without its attendant risks. These, and a detailed discussion of the taxation of the private annuity transaction, are discussed at length herein under "Private Annuities."

A special kind of annuity is the variable annuity. Whereas, the private annuity is basically aimed at tax savings, the variable's goal is economic growth. When we speak of variable annuities, we are concerned in the main with group employee annuities which are part of a corporation's deferred compensation program. Again, to contrast: the private annuity is a transaction entered into on an individual basis and it is likely to involve a person who is self-employed, while the group variable annuity offers tax and economic advantages to the salaried person. The aim of this article is to explore both programs in the context of their tax and economic issues. Since the private annuity has the economic disadvantages of any fixed income interest, the following question must be answered: is there some way to engraft upon the private annuity, whose stated purpose is to minimize income, gift and estate taxes, the idea of the variable annuity, a creation of commercial insurers, whose goal is to counter the inflationary erosion of the dollar? Again, with respect to private annuities, will arrangements in which the transferor's interest is tied too closely to the property transferred, thereby giving a greater assurance of continued payments and a sharing in the appreciation of the property, assume the character, and, thus the tax rules for a trust?\textsuperscript{17}

At this point it may be of interest to examine some of the basic definitions relating to annuities generally before considering variable and private annuities and tax planning for these.

\textit{Definitions, Basic Advantages, and Types of Annuities}

An annuity is an agreement providing for the periodic but regular

\textsuperscript{16} Exclusion from the gross estate of the value of the property, or of any survivorship rights in the annuity contract, will depend upon meeting the requirements of \textsc{Int. Rev. Codex} of 1954, §§ 2035, 2036, 2039.

\textsuperscript{17} See Archbishop Samuel Trust, 36 T.C. 641 (1961), \textit{aff'd sub nom.}, Samuel v. Commissioner, 306 F.2d 682 (1st Cir. 1962). If the arrangement is in reality an annuity, it would be taxed accordingly, \textit{i.e.}, under section 72, as amplified by existing Revenue Rulings dealing with private annuities. On the other hand, where a trust is created, which includes a provision to make payments to a beneficiary taking the form of an annuity the payments will be taxed under the trust rules of the \textsc{Int. Rev. Codex} of 1954, Sub. Ch. J. Pt. I.
payment of a sum certain, beginning at a fixed date and continuing throughout one or more lives, or for a term of years.\textsuperscript{18} The governing income tax statute, section 72 of the Internal Revenue Code of 1954,\textsuperscript{19} also specifies that an amount paid under an annuity contract will not be construed as an annuity payment, which would thereby entitle it to a beneficial tax treatment, unless it is paid after the annuity starting date and is payable by its terms over a period of not less than one full year from the date on which the annuity payments are considered to begin.\textsuperscript{20} This annuity payment, conceptually and statutorily, represents both a return of capital and interest.\textsuperscript{21} Its dual character has been the primary cause of its sometimes complex tax treatment.

The character of each payment as partly a return of capital and partly interest may be illustrated by a simple example:

The taxpayer, $A$, purchases an annuity contract for a consideration of $\$15,000$ with an expected return of $\$20,000$. An "exclusion ratio" will be applied to each payment. The numerator is his investment in the contract. The denominator is his expected return. Thus, the exclusion ratio which $A$ will use is $\frac{\$15,000}{\$20,000}$, or 75 percent. This means that 75 percent of each payment will be considered a return of capital, and excludible, and 25 percent as taxable income. If $A$ were to receive $\$1,000$ annually, he would exclude $\$750$ ($\$1,000 \times 75\%$) from gross income as return of capital. The balance of $\$250$ ($\$1,000 - \$750$) would be includible in gross income.\textsuperscript{22}

Consideration, or the investment in the annuity contract, for the obligor’s promise to make periodic payments, may be money or property. These payments may be for a definite period, as ten years, or as is more usual, for an indefinite one, as the annuitant’s life. The obligor may be a commercial entity, as an insurance company which regularly issues annuity policies, or a private person, including not only an individual, but a public charity or a private foundation or any other entity which is not in the business of regularly writing annuity contracts.

The fixed income annuity assures a periodic and certain payment to

\begin{itemize}
  \item \textsuperscript{18} Treas. Reg. § 1.72-2(b)(2)(ii) (1966).
  \item \textsuperscript{19} Int. Rev. Code of 1954, § 72.
  \item \textsuperscript{20} Treas. Reg. § 1.72-2(b)(2)(i)-(iii) (1966), 1.72-4(b)(1) (1956).
  \item \textsuperscript{21} Id. § 1.72-1(a) (1963).
  \item \textsuperscript{22} Id. § 1.72-4(a) (1)(i)-(iii), (2) (1956).
\end{itemize}
the annuitant for the term of the contract. This guarantees financial security, particularly for those seeking income in their later years when their ability to earn is diminished or nonexistent. The annuitant is also relieved of investment and management duties with respect to the capital which has been invested in the annuity contract. These are assumed by the obligor undertaking that the investment will generate sufficient income to make the stipulated annuity payments. Additionally, by purchasing an annuity the annuitant increases his purchasing power since the certain payment, usually for life, will allow him to consume other capital not invested in the annuity contract. Otherwise the blessings of longevity might be financially straining since one must have sufficient capital invested to provide a living income. An annuity transfers this risk.

Another advantage of an annuity is the removal of assets from the annuitant’s taxable estate as long as survivorship rights do not exist. This is more significant for the private annuity since the disposition of property in a private annuity enables the annuitant to transfer property during his lifetime to the persons who would ordinarily take after his death. This allows one to continue to enjoy the fruits of property during his life while avoiding estate and inheritance taxes.

Annuities may be classified in three ways: according to the obligor: commercial, private, charitable, or employment; according to the obligee or annuitant: period certain, straight life, survivor, or refund; or, according to the income interest created: fixed, variable, or some combination thereof.

A commercial annuity involves a contractual relation with a commercial organization, such as an insurance company regularly engaged in the business of issuing such contracts. When the obligor is not so regularly engaged, this is a private annuity. It may be with an individual, as in the intra-family situation, a charitable organization, or any entity not regularly engaged in the business of issuing annuity contracts. Where property rather than cash is exchanged for an annuity, the tax consequences of the transfer, i.e., whether gain must be recog-


24. INT. REV. CODE OF 1954, § 2039. A detailed discussion of the estate tax consequences of annuities is included below.

nized immediately upon the transfer, will be dependent upon whether or not it is a private annuity transaction, which, in turn, is dependent upon the nature of the obligor.

An employee annuity contract is part of a deferred compensation program. It is a plan which takes the form of a contract providing for annuity payments on the employee's retirement.26 The benefit of the plan is increased in proportion to the employer's percentage of the total contributions made under the contract, as well as by early vesting and nonforfeitability features.

A more generic categorization of annuities is based upon the obligee, or, in other words, the terms and duration of the payments which will be made to the annuitant. There are a number of possibilities. First, the "period-certain" annuity provides for payments for a set time, terminating upon an expiration date irrespective of whether or not the annuitant is still alive. Thus, the "period-certain" annuity somewhat obscures the more fundamental rationale of annuities of shifting risk to guarantee oneself income for life unencumbered by management burdens. This purpose is accomplished by the straight life annuity which provides for payments during the life of the single annuitant with the obligor's duties terminating upon the annuitant's death.27 Income may also be paid to two or more persons for their lives under a joint and survivor annuity. After the death of one of the annuitants the obligor continues payments to the survivor for life.28 If the annuitant wishes to assure the return of his capital investment upon a premature death, i.e., before the actuarial prediction, he will undoubtedly want a refund annuity. In that case, should he die prior to recovering his cost or investment, the payments will continue to his estate or alternate beneficiaries until the investment is recovered. This deficiency may be made up in a lump sum rather than as a continuing payment. This is a cash refund annuity.29 Finally, the annuity contract premium may be paid at one time or over a number of years, and the annuity payments themselves may be either immediate, as would usually

26. An employee annuity may be part of a qualified, trustee pension or profit-sharing plan, or it may be purchased directly by the employer for the employees from an insurer. Int. Rev. Code of 1954, §§ 401, 403.
28. See generally S. Foosaver, Taxation of Life Insurance and Annuities § 3.04, at 43 (1960).
29. Id. § 3.18, at 77-78; see also Int. Rev. Code of 1954, § 72(c) (2); Treas. Reg. § 1.72-7 (1956).
be true when the annuity premium is paid at once, or deferred, commencing in the future, usually at retirement or a specified age.

Annuities, with the exception of the variable annuity, are essentially fixed income interests. As indicated above, this tarnishes their glamour as investments in an inflationary period and results in insurers issuing the variable annuity, which is designed to give the annuitant an income interest represented by "units" in an equity fund capable of growing with inflation. In contrast to a fixed income annuity, the annuity payment under a variable contract is determined by the value of the unit share in the investment portfolio.

**Income Tax Treatment**

The income tax treatment of annuities has gone through three stages. Prior to 1934 no tax was imposed upon an annuity payment until these had exceeded the investment in the contract.\(^30\) Thereafter, all payments were fully includible in income. Thus, while the early years were unburdened, the tax load in later years became unduly onerous.

Recognizing that an annuity payment represents both a capital and interest element, the 1934 Revenue Act, as re-enacted by the 1939 Code, provided that a part of each annuity payment—equal to three percent of the aggregate consideration paid for the annuity contract—would be deemed interest and includible in income.\(^31\) The balance of each annual payment was deemed to be a return of capital. After this portion had equalled the consideration paid, the total of each annual installment thereafter was included in the annuitant's taxable income.

The arbitrary three percent rule was abandoned by the 1954 Code. That rule had taken no account of the annuitant's age. The larger the investment in the contract, the higher the interest element of each payment under the three percent rule. An annuitant might be required—because of a very large investment, upon which the three percent was applied, and a relatively small annuity in relation to this amount—to live well beyond his actuarial expectancy in order to recover his investment in the contract. The rule made no exception for that case.\(^32\) This tax burden would substantially reduce the annuitant's purchasing power.

\(^{30}\) George H. Thornly, 2 T.C. 220 (1943), rev'd on other grounds, 147 F.2d 416 (3rd Cir. 1947).
\(^{31}\) Int. Rev. Code of 1939, § 22(b)(2).
\(^{32}\) Clairmont L. Egtvedt, 112 Ct. Cl. 80 (1948).
and, concomitantly, his standard of living, which vitiates the very purposes of the annuity transaction.\textsuperscript{33}

Section 72 of the 1954 Code adopts the theory of the three percent rule, \textit{i.e.}, a part of each payment is principal and a part is interest.\textsuperscript{34} It does this, however, not by choosing an arbitrary percentage, but through applying an “exclusion ratio” principle to each annuity payment to allocate a part of each payment to a return of capital and a part to interest.\textsuperscript{35} Once the exclusion ratio is established at the annuity starting date, it is uniformly applied throughout the period of the annuity payments even after the annuitant has recovered the full amount of his investment.\textsuperscript{36} Thus, the long-lived annuitant will have a “mortality gain” while his short-lived counterpart will have a “mortality loss.” The ratio does not, however, apply to payments received upon transfer, surrender, redemption, discharge, or modification of the annuity contract.\textsuperscript{37} These amounts will be included in income to the extent that they, when added to the principal payments previously received, exceed the annuitant’s investment in the contract.\textsuperscript{38}

The annuitant’s “investment in the contract” consists of the aggregate premiums or other consideration paid for the policy,\textsuperscript{39} reduced by (a) any payments received under the contract prior to the annuity starting date which were excludible from income,\textsuperscript{40} and (b) the value, as of the annuity starting date, of any refund feature contained in the contract.\textsuperscript{41}

The “expected return” is computed by the actuarial life of the annuitant,\textsuperscript{42} or, where there is more than one annuitant, by aggregating the total life expectancies of the annuitants.\textsuperscript{43} The Treasury Regulations establish annuity tables giving the “expected return multiples” to be used.\textsuperscript{44} The anticipated annual payment is multiplied by the multiple specified for a person of the given age and sex.\textsuperscript{45} Fractional adjustments

\textsuperscript{33} It must be remembered that one purpose, at least, of an annuity is to provide the annuitant with a lifetime income to maintain a certain standard of living.
\textsuperscript{34} \textit{Int.
 Rev.
 Code
 of
 1954}, § 72(b).
\textsuperscript{35} \textit{Id.} §§ 72(b)-(c).
\textsuperscript{36} Treas.
 Reg.
 §§ 1.72-4(a)(4) (1956).
\textsuperscript{37} \textit{Id.} §§ 1.72-4(a)(4)(i)-(ii) (1956).
\textsuperscript{38} \textit{Id.} §§ 1.72-11(d)-(e) (1966).
\textsuperscript{39} \textit{Int.
 Rev.
 Code
 of
 1954}, §§ 72(c)(1), (2).
\textsuperscript{40} \textit{Id.} § 72(c)(1) (B).
\textsuperscript{41} \textit{Id.} § 72(c)(2).
\textsuperscript{42} \textit{Id.} § 72(c)(3)(A).
\textsuperscript{43} Treas.
 Reg.
 § 1.72-5(b)(2) (1956).
\textsuperscript{44} \textit{Id.} § 1.72-9 (1967).
\textsuperscript{45} \textit{Id.} § 1.72-5(a)(1) (1956).
to the expected return multiple may be required if the payments are to be made quarterly, semi-annually, or annually. If the interval of time between the annuity starting date and the first payment is less than the interval between future payments, a further adjustment in the expected return multiple also may be required.\textsuperscript{48} Certain modifications are made upon this formula for the variable annuity.\textsuperscript{47}

\textit{Joint and Survivor Annuities}

Many annuitants choose the joint and survivor annuity in which payment is made to an original annuitant for life, and upon his death to a named survivor for his or her own life. This is the typical contract which a married annuitant will select.

Under the 1939 Code, the original annuitant and the surviving annuitant were treated as though they were one person;\textsuperscript{48} the full amount paid for the entire policy was treated as the investment and the sum upon which the three percent rule was applied. This three percent rule was applied to payments received not only by the original annuitant but by the survivor as well until such time as the total consideration had been received, regardless of who—the primary annuitant or the survivor—was receiving the payments. The Revenue Act of 1951, which is still followed in the 1954 Code where the first annuitant had died after 1950 and before 1954, modified the single contract theory, treating the primary annuitant and the survivor as one in some cases.\textsuperscript{49} It provided that if the survivorship interest had been included in the primary annuitant's estate, the survivor's basis for his interest would be its estate tax value in the decedent's estate.\textsuperscript{50} This basis was then used to compute under the three percent rule, the amount of each annuity payment received by the survivor that would be treated as income. Thus, the survivor's interest in such a case would be determined only as of the date of death of the primary annuitant.\textsuperscript{51} After 1953, this figure, reduced by any excluded payments received by the surviving annuitant before 1954, is treated as his cost for the purpose of the ex-

\textsuperscript{46} Id. § 1.72-5(a) (2) (i).
\textsuperscript{47} Id. § 1.72-5(f) (1) (1956), § 1.72-2(b) (3) (1966).
\textsuperscript{48} Int. Rev. Code of 1939, § 22(b) (2); see also Virginia M. MacArthur, 8 T.C. 279 (1947), aff'd, 168 F.2d 413 (8th Cir. 1948).
\textsuperscript{50} Id.
\textsuperscript{51} This was deemed to have been the consideration paid for the survivor's annuity for the purpose of determining the taxable amounts of the annuity payments received by the survivor.
The rule for joint and survivor annuities purchased before 1954 and received after 1954 is based, with the exception of the fair market value basis adopted for some cases, upon the general rule of section 72 for annuities bought before 1954 and continued to be received thereafter. The old three percent rule no longer applies. Rather, the annuity starting date becomes January 1, 1954, and the exclusion ratio is determined as of that date. The investment in the contract is the aggregate amount of premiums or other consideration paid for the contract minus the aggregate amount received under the contract before 1954 to the extent that such amounts were excludible from gross income. The expected return is also determined as of that date.

The 1954 Code treats both annuitants as one, except where the amount of the annuity to be paid the survivor differs from that paid the original annuitant. The survivor continues, without adjustment, the same exclusion ratio as the primary annuitant, when the amount of the annuity payment will be the same as that made to the primary annuitant. The cost and aggregate expected return are computed for, and to be taken into account by, both annuitants. The primary annuitant will thus realize a greater amount of income than he would under a straight life annuity because the combined life expectancies of the annuitants gives a larger multiple, and, consequently, a greater expected return. Where the contract establishes a different monthly income for the second annuitant, the expected returns for each are computed separately and then aggregated to give the total expected return figure. Once this figure is ascertained, the usual rules apply.

**VARIABLE ANNUITIES**

**Background: Investment Experience**

The tax aspects of variable annuities do not present issues drastically different from other kinds of annuities. The principal questions pertaining to the variable annuity have concerned its status as a “security” under the Securities Act of 1933, the insurers’ posture under the Invest-
ment Company Act of 1940 and the economic matter of investment experience. Most of the discussion in this Part will focus upon these issues. Moreover, since the variable annuity is usually issued in connection with group plans, the taxation of employee annuities also will be taken into consideration.

A plethora of reasons led to the introduction of, and modifications upon, the variable annuity. Principal among these, as stated above, was the inability of a fixed dollar annuity to appreciate with inflation and thereby assure the real and constant purchasing power of retirement income. A variable annuity is based upon equity funding. It represents a promise by the obligor to pay the annuitant, whose interest is represented by units in a fund of fluctuating value, an indeterminate income, rather than a fixed amount. Since inflation has resulted in fixed income investments becoming less attractive, investment funds, including those of large pension trusts, have been placed in equities. Competition by banks and trust companies, as well as by mutual funds, for these investment dollars stimulated the initiation of the variable annuity by insurers. These other institutions were able to invest a portion of their portfolios in equities, while insurers traditionally had been limited to investing in fixed assets, such as corporate and Treasury bonds and real estate mortgages. As the performance of equity-type funds exceeded those of the insurance companies, dollars were switched from annuities to programs emphasizing equity funding. The variable annuity thus represented in large part a response to this competition.

The variable annuity was first offered in 1952 when the Teachers’ Insurance and Annuity Association of America (TIAA), formed the College Retirement Equities Fund (CREF), as a separate entity to sell variable annuities in conjunction with TIAA fixed dollar annuities. As its name indicates, CREF funds are invested in common stocks in

62. See note 4, supra.
63. Prior to 1952 commercial annuities were of the fixed income type. CREF's first variable annuity certificate was sold to the then president of Brown University.
64. This association was formed in New York in 1918 on a grant from Andrew Carnegie to provide life insurance and pension benefits to teachers and staff members of educational institutions.
65. CREF was established in 1952 by a special act of the New York State Legislature and was placed under the supervision of the New York State Insurance Department.
66. E.g., at the end of 1965 there were “79 companies in 17 industries represented in CREF's portfolio. The five largest of these [were] public utilities, which at the end of 1965 represented 14 per cent of the total; oils, 13 per cent; chemicals, 9 per cent; office equipment companies representing 8 per cent, and electronics, 7 per cent.” Greenough, The Variable Annuity—the College World's Experience, 20 J. Am. Soc'y C.L.U. 253, 256 (1966).
contrast to the fixed type of obligations held by TIAA. As the program has developed, each member has been permitted to allocate up to seventy five percent of his premiums to the equity fund while the remaining amount must be placed in TIAA. Upon retirement the annuitant receives two checks each month: one from TIAA which remains constant from year to year, the other from CREF which will vary in amount, depending upon the performance of the equity fund during the previous year. The true value of this combination approach to savings is the ability to reduce the dangers of recession by the fixed fund, while at the same time furnishing a hedge against inflation through the variable annuity. Furthermore, since CREF is designed as a long

67. TIAA-CREF Ann. Rep. 20 (1968). This rule became effective January 1, 1967. Prior to that time a maximum of fifty percent could be contributed to CREF.

When a premium payment is made to CREF the participant is credited with a certain number of "accumulation units," which in effect represent a share in CREF's investment portfolio. The number of "accumulation units" that each payment will buy depends upon the size of the premium and the current "unit" value, as computed monthly. Suppose, e.g., that the unit value is set at $10 and a $500 annual premium is made by the participant; sixty accumulation units would thus be purchased. As the value of these units rises or falls, there would be a corresponding increase or decrease in the number of units that the same premium will purchase. These units will continue to accumulate until the retirement date, at which time a computational change is made, according to the terms of the contract, converting the accumulation units into a lesser number of "annuity units." During the entire annuity pay-out period the number of annuity units will remain constant, but their value will fluctuate with the investment experience of the fund. The annuitant will receive a monthly annuity payment based on the number of annuity units accumulated multiplied by the cash value of these units, recomputed yearly. Assume that A has accumulated ten annuity units. If, at the beginning of 1968, these units were valued at $30, he would receive $300 a month for that year. At the beginning of 1969, the value may have risen to $45 or declined to $40. In the former case he would receive $450 per month; in the latter case, $400 per month.

68. Suppose, e.g., that an annuitant had purchased a monthly $100 fixed annuity from TIAA, and at retirement date had also accumulated ten CREF annuity units. If, in the first year of the pay-out, i.e., the annuity period, the annuity units were valued at $20 he would receive each month, in addition to the fixed $100 annuity from TIAA, a $200 annuity from CREF. At the beginning of the next year the unit value might be $40, or, conversely, it may have declined to $10. In the latter case, his fixed annuity would provide a cushion for this reduction in the CREF annuity. In the former case the rise in the equity portion would give him an extra $400, rather than $200 per month, thus growing with inflation. Assuming that this same investment would have purchased a $400 fixed annuity, the annuitant would be better off by selecting this two-fund approach. But, again, while the potential growth in retirement dollars from CREF is indeed enticing, it must be emphasized that a protracted recession after commencement of the annuity period could be disastrous to the investor who had put all of his retirement dollars into variable annuities. Hence, the two-fund approach adopted by TIAA-CREF, which is intended to protect the investor against recession as well as inflation.
term program, which for most members should involve many years of participation, the annuitant will not be vulnerable to the level of stock prices at any one time. Purchases will be price-averaged because the fund will buy in periods of stock market declines as well as advances. Therefore, a short term market decline may prove to be advantageous in the long run to the participant because of the ability of the fund to make investments at lower prices. The performance of TIAA-CREF has borne out its theoretical soundness. The following table shows how the annuity income provided by the program has grown over the years.

TIAA-CREF INCOME ILLUSTRATION
1952 - 1966

<table>
<thead>
<tr>
<th></th>
<th>TIAA Income</th>
<th>CREF Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1952-53</td>
<td>$100.00</td>
<td></td>
</tr>
<tr>
<td>1953-54</td>
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<tr>
<td>1954-55</td>
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<tr>
<td>1955-56</td>
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<td>1956-57</td>
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<td>1957-58</td>
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<td>1958-59</td>
<td>$108.54</td>
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<td>1959-60</td>
<td>$112.12</td>
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<td>1960-61</td>
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<tr>
<td>1961-62</td>
<td>$112.43</td>
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<td>1962-63</td>
<td>$112.43</td>
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<td>1963-64</td>
<td>$112.43</td>
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<td>1964-65</td>
<td>$112.43</td>
<td></td>
</tr>
<tr>
<td>1965-66</td>
<td>$112.43</td>
<td></td>
</tr>
<tr>
<td>1966-67</td>
<td>$112.43</td>
<td></td>
</tr>
</tbody>
</table>

Total Monthly Income

*Includes extra dividend due to adjustment for the change in mode of dividend payments from annual basis to monthly basis.
unit had more than tripled between 1952 and 1969, growing from ten dollars in 1952 to over thirty dollars in 1969.\textsuperscript{70} CREF has received an enthusiastic response from educational institutions.\textsuperscript{71} More recently, commercial insurers have developed similar programs.\textsuperscript{72}

**Federal Securities Aspects**

Commercial insurers have had two principal concerns with respect to the variable annuity contract. The first of these was whether a variable annuity contract constituted a "security" under section 2(1) of the Securities Act of 1933 and thus was required to be registered prior to a sale or offer to sell.\textsuperscript{73} The second was whether the insurer

\begin{itemize}
  \item A single payment, on July 1, 1952 (the date of the first offering of CREF annuities), for a TIAA-CREF immediate annuity, when the purchaser was 65 years old, and to produce a payment of $100 from TIAA and $113.95 from CREF for a total of $213.95 (or $214 rounding off to the nearest dollar), would have resulted by 1966-67 in this total combined annuity payment to the original annuitant, or his survivor, or a beneficiary, growing to $459 (rounding off to the nearest dollar) made up of $112.43 in a TIAA payment and $346.75 in a CREF payment. Greenough, supra note 66, at 257-58.
  \item The annuity unit is revalued on March 31 of each year, which sets the value of the annuity unit payments for the next May 1 through April 30. TIAA-CREF ANN. REP. 23 (1968). The annuity unit was valued on March 31, 1967, at $31.92 for the period May 1, 1967, to April 30, 1968; on March 31, 1968, however, the annuity unit's value had declined, due to stock market reversals, to just below $30; on that date it was valued at $29.90 for the period May 1, 1968, to April 30, 1969. On March 31, 1969 the annuity unit was valued at $32.50 for the period May 1, 1969, to April 30, 1970.
  \item Although enrollment is limited primarily to college and university staff members (non-profit and tax exempt educational and scientific organizations may also be eligible to participate) the number of members has grown to over 320,000 today. Id. at 21.
  \item These include, e.g., Participating Annuity Life Insurance Co. (PALIC); Variable Annuity Life Insurance Co. of America (VALIC); Equity Annuity Life Insurance Co. (EALIC); The Gibraltar Fund of Prudential Insurance Co.; American Republic Assurance Co. (Separate Account B); John Hancock; Connecticut General; Travelers; Occidental; and Metropolitan Life. It is interesting to note that Metropolitan Life was a strong opponent to the concept of variable annuities when they were first introduced and its position was typical of commercial insurers at the time. See Morrisey, Dispute Over the Variable Annuity, 35 Harv. Bus. Rev. 75 (1957).
  \item Section 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1964), defines a "security" as:

\begin{itemize}
  \item any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary
\end{itemize}
\end{itemize}
was subject to the Investment Company Act of 1940.\textsuperscript{74} In \textit{SEC v.}

or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Section 5 of the Securities Act of 1933, 15 U.S.C. \textsection{77e} (1964) provides:

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly —

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly —

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.

\textsuperscript{74} Section 3 of the Investment Company Act of 1940, 15 U.S.C. \textsection{80a-3(a)} (1964) defines an “investment company” as:

any issuer which—

(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

(2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

Without undertaking an elaborate discussion of the Investment Company Act of
Variable Ann. Life Ins. Co., 76 [hereinafter VALIC], the Supreme Court rejected VALIC's contention that the variable annuity contracts which it was selling were in the nature of insurance rather than investments and therefore exempt from registration under the Securities Act of 1933, and the insurer, itself, exempt from the Investment Company Act of 1940. 76 The variable annuity contract in issue provided for the investment of premiums in an equity fund; upon retirement, the annuitant was credited with a fixed number of units in the fund; these, and, consequently, the annuity payments, would fluctuate with the investment performance of the fund. The Supreme Court held these contracts to be investment type securities under the 1933 Act. 77 The Court noted that they offered "no true underwriting of risks, the one earmark of insurance as it has commonly been conceived of in popular understanding and usage." 78 The contract, rather, made no guarantee of any payment whatsoever; thus, the investment risk fell completely upon the individual without any assumption of risk by the insurer.

1940, an insurer which is deemed to be an investment company would be required to register with the Securities and Exchange Commission and make the following disclosures:

(a) investment policies and operating practice (§ 8, 15 U.S.C. § 80a-8 (1964));
(b) affiliations of directors, officers, and employees (§ 10, 15 U.S.C. § 80a-10 (1964));
(c) relation of investment advisers and underwriters of the investment company (§ 15, 15 U.S.C. § 80a-15 (1964));
(d) transactions of certain affiliated persons and underwriters (§ 17, 15 U.S.C. § 80a-17 (1964));
(e) capital structure of the investment company (§ 18, 15 U.S.C. § 80a-18 (1964));
(f) dividend policy (§ 19, 15 U.S.C. § 80a-19 (1964));
(g) loans by management companies (§ 21, 15 U.S.C. § 80a-21 (1964));
(h) detailed reports of accounts and records to investors (§§ 29, 30, 15 U.S.C. §§ 80a-29, 30 (1964)).

75. 359 U.S. 65 (1958).

76. The Securities Act of 1933 specifically exempts from its coverage any "insurance policy" and any "annuity contract" (§ 3(a)(8), 15 U.S.C. § 77c(a)(8) (1964)). The Investment Co. Act of 1940 specifically exempts from its coverage any "insurance company" (§ 3(c)(3), 15 U.S.C. § 80a-3(c)(3) (1964)) defined as:

a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State . . . . (§ 2(a)(17), 15 U.S.C. § 80a-2(a)(17) (1964)).

77. 359 U.S. at 73 (1958).

78. Id. at 71.
After retirement, for example, a prolonged stock market decline might reduce the variable annuitant's retirement income dramatically, even potentially to nothing, as no minimum payment had been warranted by the company.

In an attempt to circumvent VALIC, the United Benefit Life Insurance Company developed the "flexible fund" deferred annuity contract. This modification of the basic variable annuity differs in two respects. First, during the accumulation period, although premiums are invested in the insurer's "flexible fund" account, primarily a common stock fund, there is a "net premium guarantee" feature. The net premium represents the premiums paid by the participant less a deduction for the insurer's expenses. The "net premium guarantee" is a provision under which the insurer agrees to pay to the participant, prior to maturity, a specified percentage of his total net premiums. This amount gradually increases from fifty percent of that sum in the first year to one hundred percent after ten years. The second distinct feature is that at maturity, the annuitant has the option of receiving either the cash value of his interest in the flexible fund, or his "net premium guarantee," whichever is greater. Further, in lieu of accepting cash, as measured in either manner, the annuitant may elect to convert his benefits into a conventional fixed dollar annuity.

The Securities and Exchange Commission instituted an action to enjoin United from selling unregistered flexible fund annuity contracts. In SEC v. United Benefit Life Ins. Co., the Supreme Court held such a flexible fund annuity contract to be a security under section 2(1) on the grounds that United's assumption of the investment risk during the accumulation period was insufficient to constitute an insurance contract. The Court emphasized that there is a "basic difference between a contract which to some degree is insured and a contract of insurance." This contract did not, in its opinion, represent a substantial risk-taking by the insurer assuring the value of the investment throughout the accumulation period.

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82. Id. at 207-12.
83. Id. at 211.
84. Id. at 208-10. The issue of whether the insurer was required to register the "Flexible Fund" with the Securities and Exchange Commission under § 8 of the Investment Company Act of 1940 had not been considered by the courts below, and, therefore, the Supreme Court remanded this issue to the court of appeals. Id. at 212.
1969] VARIABLE AND PRIVATE ANNUITIES

Types of Variable Annuities

Variable annuity contract premiums are applied to purchase "ac-

The latest development in securities regulation of insurers selling variable annuity contracts is an announcement by the SEC issued on January 24, 1969, in the form of proposed rules covering exemptions from certain requirements of the Investment Company Act of 1940. The proposed rules would allow an insurer selling variable annuity contracts to be exempt from the following provisions of the Act:

(a) the $100,000 minimum net worth requirements of §14(a) of the Inv. Co. Act;

(b) the investment adviser, directors, and independent public accountants would be permitted to act without shareholder approval, (as is now required by §§15(a), 16(a), and 32(a) respectively of the Inv. Co. Act), until the first meeting of the variable annuity contract owners;

(c) variable annuity contracts whose program of annuity payments are founded upon life expectancies would no longer be required to meet the redemption requirements, (i.e., a shareholder must currently have the right of redemption during the pay-out period) of §§ 22(e) and 27(c) (1) of the Inv. Co. Act;

(d) variable annuity contracts would be exempt from §§ 27(a) (1) and (3) of the Inv. Co. Act, which now prohibits a "sales load" on any "periodic plan certificate" from exceeding nine percent of the total payments to be made thereon; the nine percent limitation would apply only after the twelfth year; (this is in conformity with current practice of insurers to impose a higher "load" charge in the early years of the contract, in order to compensate for the costs of sale); also, more flexibility would be permitted in reducing the sales load charges;

(e) if the variable annuity contract meets the requirements of §§ 401 or 403 of the Int. Rev. Code of 1954, for trusteed or insured employee annuities, then the contract would be exempt from § 27 (a) (4) of the Inv. Co. Act, which now prohibits the first payment to the annuitant under the plan to be less than $20 and any subsequent payment to be less than $10.

In order to qualify for these exemptions, the insurer must maintain with respect to its variable annuity contracts a separate account and adequate reserves, not chargeable with liabilities arising out of any other business conducted by the insurer. The term "separate account" is defined in Proposed Rule O-1(e) as follows:

Unless otherwise specified or the context otherwise requires, the term "separate account" shall mean a legally segregated asset account established and maintained by an insurance company pursuant to the law of any state or territory of the United States or the District of Columbia, under which income, gains, and losses, whether or not realized, from assets allocated to such account are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company, the assets of which account have a value of at least equal to the reserves and other contract liabilities with respect to such account; and that portion of such assets, which has a value equal to the reserves and other contract liabilities of such account, is not chargeable with liabilities arising out of any other business which the insurance company may conduct.
cumulation units" or shares in a flexible investment portfolio.\textsuperscript{85} Upon retirement, the participant’s accumulation units are converted into a fixed number of "annuity units" for the duration of the contract. The monthly payment will then depend upon the changing value of the annuity units as a result of the rise or fall of the investment portfolio.\textsuperscript{68}

Any annuity may be purchased either on an individual or group contract basis. The economic difference for the annuitant is that the former will be acquired with after-tax dollars, whereas if the latter is part of a qualified deferred compensation plan,\textsuperscript{67} both the employer’s and employee’s contributions to it will be excluded from the employee’s income when the contributions are made,\textsuperscript{87} and the employer will be entitled to a deduction for his contribution to the plan.\textsuperscript{88} The individual variable annuity contract may either be deferred, meaning that annuity payments are to start at a later date, purchased by payment of a lump sum or by installment payments; or, it may be an immediate annuity, meaning that annuity payments will commence at once upon payment of a lump sum. Each annuitant has his own contract with the insurer. As explained above, there are several modifications which may be made to the variable annuity model.

Group variable annuity contracts\textsuperscript{90} have developed to fund employee pension or profit sharing plans. They differ from individual annuity contracts in that a single master contract is used to cover all participants. Title, or ownership of the contract, is vested in a trustee for the benefit of all the participants, rather than in the employee, as in an individual variable annuity contract. These contracts are designed basically for pension or profit sharing plans which include over twenty-five par-

\textsuperscript{85} See supra note 67.

\textsuperscript{86} For an illustration as to how this would operate, see notes 67 and 68 supra. It may be noted that these annuity units may be valued annually, or more often (with an apparent absence of consistency between insurers as to the appropriate valuation date). \textit{E.g.}, CREF values its annuity units on March 31 of each year; PALIC uses a monthly valuation period; American Republic Assurance Company revalues its annuity units as of the close of business on each day during which the New York Stock Exchange is open.

\textsuperscript{87} \textsc{int. rev. code of 1954}, §§ 401 (a), 403 (a).

\textsuperscript{88} \textit{id.} § 403 (a); \textsc{treas. reg.} § 1.403 (a)-1 (a) (1966).

\textsuperscript{89} \textit{id.} § 404 (a) (2).

\textsuperscript{90} \textsc{2 casby, pay planning}, § 11,381-81.6 (1969).
Flexibility is achieved through three different mechanisms: deposit administration, unit purchase, and profit sharing.

Under a deposit administration program the employer's contributions acquire accumulation units, which are allocated or credited to an employer's "purchase payment account," but the employee has no direct interest in the fund itself. When he retires, an appropriate number of accumulation units are withdrawn from the fund to purchase a variable annuity contract for the employee. The unit purchase contract differs from the deposit administration in that the employer's contributions are credited initially to the account of an individual employee rather than to a general fund. Variable annuity units are purchased, the number depending upon the age and sex of the employee and the annuity unit value at the time of contribution. Upon retirement, payments will be made to the participant based upon the number of units to his credit at that date. A profit-sharing program is used only in connection with deferred profit-sharing plans under which the employer's contributions are determined according to company profits and thus may fluctuate widely from year to year. The contributions are applied to purchase paid-up variable annuity units for each participant on the unit purchase principle.

A new idea for variable annuities, stemming again from performance conscious competition for pension dollars, is the "investment" variable annuity. The plan adds an incremental payment to the annuity which would otherwise be payable if the fund increases in value during the year by more than a certain percentage over the previous year's value. On the other hand, if the fund's performance is below that expected rate of growth, the annuity payment for the following year will be correspondingly reduced. Emphasis is again upon better management as manifested by investment experience.

The purchaser of a variable annuity is given the same options as the fixed income annuitant as to available pay-out alternatives; i.e., life, joint and survivor, period-certain, or cash refund. Of course, the payment will vary dependent upon the option selected. Insurers which have issued the variable annuity contract give the annuitant the op-

91. Id. at ¶ 11,381.4.
92. The "investment" variable annuity has been sold by the First Investment Annuity Company of America (FIAC). Id. at ¶ 11,384-86.5.
93. See the discussion of the types of annuities supra. See also, e.g., PALIC Prospectus, Individual Variable Retirement Annuity Contracts 18-19 (1968); PALIC Prospectus, Pension Trust Variable Retirement Annuity Contracts 18-19 (1968); American Republic Assurance Company Prospectus (Separate Account B) 12-13 (1968).
portunity to allocate a percentage of his premium to a variable annuity purchase and the balance to a fixed-dollar annuity purchase, thus selling a combination investment.  

Tax Consequences of Variable Annuities

Where the amount of the periodic payments may vary in accordance with investment experience, cost of living indices, or similar fluctuating criteria, or where the contract otherwise provides for variable annuity payments, each payment is considered to be an amount received as an annuity only to the extent that it does not exceed the investment in the contract, divided by the number of periodic payments anticipated. In other words, payments are fully includible in income once they exceed the investment in the contract divided by the multiple in the case of life annuities or number of guaranteed payments in the case of term annuities. Payments received under such a contract are considered to be amounts received as an annuity as long as they do not exceed that part of the contract investment which is allocable to that year, and, consequently, excluded from income as a return of premiums or other consideration paid for the contract. Payments for that year in excess of this amount are fully included in income. If the taxpayer receives less than is allowed to be excluded in any taxable year, he may elect in a succeeding taxable year to recompute his investment by adding that deficit and he must also recompute the number of anticipated payments in accordance with his current life expectancy.


95. Treas. Reg. §§ 1.72-2(b) (3) (i) (a), (b) (1966).

96. Id. § 1.72-2(b) (3) (iii); See, e.g., Treas. Reg. § 1.72-4(d) (3) (iii) (1956).

Taxpayer A, a 64 year old male, files his return on a calendar year basis and has a life expectancy of 15.6 years on June 30, 1954, the annuity starting date of a contract to which § 1.72-2(b) (3) applies and which he purchased for $20,000. The contract provides for variable annual payments for his life. He receives a payment of $1,000 on June 30, 1955, but receives no other payment until June 30, 1957. He excludes the $1,000 payment from his gross income for the year 1955 since this amount is less than $1,324.50, the amount determined by dividing his investment in the contract ($20,000) by his life expectancy adjusted for annual payments, 15.1 (15.6—0.5), as of the original annuity starting date. Taxpayer A may elect, in his return for the taxable year 1957, to redetermine amounts to be received as an annuity under his contract as of June 30, 1956. For the purpose of determining the extent to which amounts received in 1957 or thereafter shall be considered amounts
The gift and estate tax consequences of the variable annuity present no peculiar differences from the basic annuity. The rules which govern the gift and estate tax treatment of annuities in general are applicable to variable annuities as well. The gift and estate tax issues will be discussed in detail below.

**Employee Annuities**

The benefit of the variable annuity which is a part of an employee deferred compensation program is increased in proportion to the employer's percentage of the total contributions made under the contract, as well as by early vesting and nonforfeitability features. The recent trend has been to make employee annuities variable so that they will have contemporary value, after many years, when the employee chooses to retire and to elect his benefits.

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97. A deferred compensation plan may provide for contributions by both the employer and employee, or simply by the employer alone. Naturally, the more an employer contributes, the more valuable the plan to the employee. Also, the sooner the employee's accrued rights under the plan become vested and nonforfeitible, the more significant the plan is to him. On the other hand, very often it is in the employer's interest to postpone for as long as possible the vesting and nonforfeitability features in order to assure the employee's continued employment. The Int. Rev. Code of 1954 does not specify any period within which the employee's rights must vest and become nonforfeitible so long as they do so by retirement, or in the case where the plan is terminated or contributions thereto are completely discontinued prior to retirement, then the employee's rights under the plan must become nonforfeitible at that time. Rev. Rul. 69-421, 1969 Int. Rev. Bull. No. 32, 4, 29; Int. Rev. Code of 1954, § 401(a)(7); Treas. Reg. § 1.401-6 (1963).
Employee annuities are specifically governed by section 403.98 If the plan is a qualified one, the employee does not have income in each year when the employer makes contributions to the plan. Rather, he does not have income under such a plan until the later year when the annuities are actually received.99 An employee annuity is thus a viable fringe benefit, deferring income from the years when his employer is making contributions on his behalf to his later retirement years.

The annuity received in the later years is governed by section 72,100 as are other kinds of annuities; however, there are certain unique rules for the employee annuity. Section 72(f)101 carves out a special rule for computing the employee's investment in the contract. This is deemed to include his own contributions and the employer's as well, to the extent that the latter were includible in the employee's gross income.102 Also taken into account in determining the employee's investment in the contract are amounts paid by the employer which would not have been includible in the employee's gross income, because of a specific tax exemption, had they been paid directly to him.103 Section 72(d)104 also sets down a special rule for employee annuities in which the aggregate amounts receivable by the employee under the terms of the contract during the first three years of payments are at least as great as his contributions. In that case the payments are fully excluded from income up to the employee's contributions. Thereafter, all amounts are fully included in income.105 The employer's contributions which are deemed to be made by the employee are used in computing the latter's cost for the purpose of determining the applicability of section 72(d).

A refund feature in an employee annuity contract reduces the annuitant's investment in the contract only to the extent that it is attributable to the employee's own investment.106

The gift and estate tax aspects of employee annuities are as follows. A gift may be made under an employee annuity program when the

99. Id. § 403(a) (1); Treas. Reg. §§ 1.403(a)-1(a), (b) (1966). Section 403 pertains to non-trusteed qualified employee annuities. If the annuity is purchased for the employee pursuant to a qualified trust, the benefits accruing to the employee will be taxed under Int. Rev. Code of 1954, § 402, rather than under § 403.
101. Id. § 72(f).
102. Id. § 72(f) (1); Treas. Reg. § 1.72-8(a) (1) (1964).
103. Id. § 72(f) (2); Treas. Reg. § 1.72-8(a) (2) (1956).
104. Id. § 72(d).
105. Id. § 72(d) (1); Treas. Reg. § 1.72-13(a) (1) (1963).
employee takes a reduced annuity in favor of continued payments to another after his death. If the plan is qualified and if the employee irrevocably during his life designates the survivorship benefits to another, the gift is exempt to the extent that the benefits are attributable to the employer's contributions.\textsuperscript{107}

The annuity payments to be received under an employee annuity plan are includible in the employee's gross estate to the extent to which they are attributable to his contributions; but employer's contributions made by reason of employment are deemed to have been made by the employee. However, section 2039 (c) sets out a very important exemption for qualified annuity plans.\textsuperscript{108} For employees dying after December 31, 1953, the employer's contributions made to an exempt plan or trust are not considered to have been contributed by the employee.\textsuperscript{109} Therefore, the value of the survivorship rights attributable to such employer contributions are not includible in the employee's gross estate. The exemption applies as well to the benefits received under a retirement annuity contract purchased directly by an employer pursuant to a plan described in section 403 (a)\textsuperscript{110} without the use of a trust, as well as employee retirement annuity contracts purchased for persons dying after December 31, 1957, by certain section 503 tax exempt organizations.\textsuperscript{111} Section 2039 (c) in the estate tax area corresponds to section 2517 which, as previously mentioned, exempts from the gift tax lifetime gifts of survivorship benefits to the extent attributable to the employer's contributions.\textsuperscript{112}

Finally, the relationship between life insurance policies and employee annuities should be observed. The proceeds of life insurance policies are included in the decedent's gross estate under section 2042\textsuperscript{113} where he retained the incidents of ownership at death.\textsuperscript{114} In view of the fact that many contracts contain both an insurance and an annuity element,

\textsuperscript{107} Treas. Reg. § 25.2517-1 (c) (1) (1963). Section 2511, and, specifically Treas. Reg. § 25.2511-1 (h) (10) (1961), establish the general rule that an election by an employee to take a reduced annuity so that continued payments may be paid to another after his death is a gift to the beneficiary at the time of the election. Section 2517 and its accompanying Regulations exempt, however, such transfers of annuities under qualified plans from the gift tax to the extent of the employer's contributions to the plan.

\textsuperscript{108} Int. Rev. Code of 1954, § 2039 (c).

\textsuperscript{109} Id. §§ 2039 (e) (1)–(2); Treas. Reg. §§ 20.2039-2 (a)–(b) (1) (2) (1963).

\textsuperscript{110} Int. Rev. Code of 1954, § 403 (a).

\textsuperscript{111} Id. at § 2039 (c) (3); Treas. Reg. § 20.2039-2 (b) (3) (1963).

\textsuperscript{112} See note 107 supra and accompanying text.

\textsuperscript{113} Int. Rev. Code of 1954, § 2042.

\textsuperscript{114} Id.
e.g., a retirement income policy with death benefits, it may become necessary to determine which type of contract, straight life insurance or annuity, exists in order to determine whether section 2039 or section 2042 applies. Generally, the test is that if at the date of death the obligor bears the risk of paying death benefits in excess of the premiums paid, it is a life insurance policy. On the other hand, if the death benefits payable cannot exceed the premiums paid, it will be treated as an annuity under section 2039.115

THE PRIVATE ANNUITY

Even with the advent of the variable annuity, private annuities, nevertheless, are generally more flexible than commercial ones inasmuch as there are a number of possible obligors as well as kinds of property which may be transferred, and conceivable arrangements. The private annuity is a means of reducing the burdens of income, gift, and estate taxation. However, as stated in the Introduction, while the private annuity may be a sound part of a tax planning program, it must be an economically advisable investment as well. The fixed income return does not appear to meet that test. Therefore, wherever possible, the obligor’s promise should provide that payments may change in accordance with the cost of living index or other fluctuating criteria. Such an idea, adopted from the commercial variable annuity, is perfectly suited to the private annuity. Indeed, the rationale for one of the benefits to the annuitant of a transfer of property for a private annuity—the prospect of deferring recognition upon the disposition—is premised upon the essentially uncertain (unfunded and unsecured) nature of the obligor’s promise. To add a variable aspect to his promise simply goes one step further in this direction and, thus, joins the economic principle of a promise to pay a variable amount with the tax saving opportunities of the private annuity. Discussion in this Part will, therefore, be concerned with the tax issues and tax planning aspects of the private annuity. While the private, or non-commercial annuity embraces all con-

115. Treas. Reg. § 20.2039-1(d) (1963). Cf. Rev. Rul. 69-146, 1969 INT. REV. BULL. No. 13, at 11, dealing with an annuity-insurance contract purchased by a § 501(c)(3) organization for one of its employees. The contract provided for insurance on the life of the insured’s spouse and children, as well as the employee. Treas. Reg. § 1.403(b)-1(c)(3) (1966) permits an annuity contract with an incidental life insurance provision to be purchased as an annuity contract within the meaning of § 403(b). Section 403(b), however, relates only to the purchase of such a contract by an employer for its employees. Since insurance protection was provided for the employee’s family as well, it was ruled, on these facts, that the contract was not a qualified annuity under § 403(b).
tracts for an annuity with persons not regularly engaged in the business of issuing annuity contracts, the two principal types have been the family annuity, where the obligor is a relative of the annuitant, and the charitable annuity, where the obligor is a charitable institution.

**Family Annuities**

A private annuity is usually purchased for property.\(^{116}\) This is deemed to be a disposition of the property and a purchase of the annuity contract.\(^{117}\) Thus, the issue of gain or loss upon that disposition is raised. It has been consistently held that the annuity contract of a private person is not the equivalent of cash, and that, consequently, any gain realized need not be recognized at the date of transfer, but rather is to be recognized at a later time on an open transaction basis as the payments are received.\(^{118}\) The reasoning has been that there is no guarantee of the collectibility of the private obligor's promise to pay the annuity since he is unregulated and under no legal compulsion to maintain reserves for contingencies and surpluses to assure his solvency.\(^{119}\) Therefore, his promise is not deemed to be the equivalent of cash.\(^{120}\)

The annuity payments, received under the private annuity contract, which is treated as an open transaction, are allocated between income and principal in accordance with the statutory formula under section 72.\(^{121}\) Additionally, the property disposed of in exchange for the annuity contract also must be taken into account. Until Revenue Ruling 69-74,\(^{122}\) issued in February of this year, the annuitant's investment in the contract was considered to be the fair market value of the property transferred in return for the annuity promise.\(^{123}\) This meant that the unrealized appreciation on the property transferred for the annuity had the effect of reducing the annuitant's subsequent income un-

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117. See, e.g., Ware v. Commissioner, 159 F.2d 542 (5th Cir. 1947); Rosen v. United States, 59-2 U.S. Tax Cas. ¶9587 (N.D. Ala. 1959).


under the annuity contract. Revenue Ruling 69-74 changes this, providing that the investment in the contract is the basis of the property transferred not its fair market value.\textsuperscript{124} Therefore, since a private annuity will involve the investment of appreciated property, a substituted and lower basis figure taken as investment will reduce the amount of the exclusion ratio, increasing the income part of each annuity payment. This may be illustrated by an example based upon the facts of the Revenue Ruling itself.\textsuperscript{125} The taxpayer, \textit{A}, age 74, transfers 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 latter’s promise to provide him with a life annuity of $7,200 per year. The expected return based on a life expectancy of 10.1 years is $72,720. The investment in the contract under Revenue Ruling 53-239\textsuperscript{126} would have been the fair market value of the property transferred, $60,000, and, thus, the exclusion ratio which \textit{A} would have used was \(\frac{60,000}{72,720}\) or 82.5 percent. Revenue Ruling 69-74, however, uses the basis of the property transferred as the investment in the contract, and, therefore, the applicable exclusion ratio will be \(\frac{20,000}{72,720}\) or 27.5 percent. The net effect of this change is to reduce the exclusion ratio, thereby substantially increasing taxable income. (Accounting for the capital gain portion of the annuity payments will be discussed below.)

The second part of the question in dealing with private annuities acquired for appreciated property is accounting for the realized gain on the property transferred. Under Revenue Ruling 53-239 which had been the rule until the new Ruling, the excluded portion of each payment would be tax free as a return of capital until the basis in the property was recovered.\textsuperscript{127} Later payments allocated to the investment would be taxed at capital gain rates up to the fair market value of the property transferred, thus accounting for the gain realized upon the disposition.\textsuperscript{128} Revenue Ruling 69-74 alters this. It assumes that the

\textsuperscript{124} Rev. Rul. 69-74, 1969 INT. REV. BULL. No. 8, at 8.
\textsuperscript{125} Id. at 8-9.
\textsuperscript{127} Id. at 54.
\textsuperscript{128} The rationale for this treatment was that the taxpayer, having engaged in a taxable disposition of property at the date of its transfer for the annuity contract, would recognize gain upon an open transaction basis. \textit{See} Burnet v. Logan, 283 U.S. 404 (1931). Inasmuch as the value of the annuity promise was the equivalent of the fair market value of the property transferred, his investment in the contract, \textit{(cf. United States v. Davis, 370 U.S. 65 (1962))}, this represented, as well, the amount realized but unrecognized
anticipated gain is capable of measurement, placing a present value upon the private obligor’s promise to pay the annuity. Then, Reve-

129. 1969 INT. REV. BULL. No. 8, at 8, uses the estate tax tables set forth in Treas. Reg. § 29.2031-7(f) to value the private obligor’s annuity promise.

It may be appropriate at this time to point up some of the differences and apparent inconsistencies in valuations which are made in connection with private annuity contracts. Valuations, for different purposes, are made under a maze of various Treasury Regulations and Revenue Rulings. Thus, in the rare case where property is sold to someone regularly engaged in the business of issuing annuity contracts, valuation of the commercial obligor’s promise, made in order to ascertain the amount realized on the transfer, would be computed pursuant to the commercial tables under Treas. Reg. § 1.72-9 (1967). In the transfer of property for a private annuity, Rev. Rul. 69-74 now imposes an immediate valuation on the obligor’s promise to pay, using the estate tax valuation tables in Treas. Reg. § 20.2031-7(f) (1967), in order to measure the present value of the obligor’s promise and the consequent amount to be realized. Where the obligor is one that issues annuities “from time to time,” as opposed to “regularly” or only on a single or isolated basis, the value of the promise is determined under several Revenue Rulings (Rev. Rul. 62-136, 1962-2 CUM. BULL. 12; Rev. Rul. 62-137, 1962-2 CUM. BULL 28; Rev. Rul. 62-216, 1962-2 CUM. BULL. 30) which evaluate such an obligor’s promise as being somewhere between the value of a commercial obligor’s promise and that of a purely private obligor. The latest in this series of Revenue Rulings, Rev. Rul. 67-39, makes it clear that these tables are to be used not only for purposes of § 72, but for all estate, gift, and income tax purposes with respect to such annuity contracts, as well as for purposes of § 72. The difference between the value of the obligor’s promise, and, thus, the amount deemed to be realized may be illustrated by the following example. Taxpayer A, age 60, purchases a life annuity of $5,000 per year from a commercial obligor. The value of the obligor’s promise, using Table 1 of Treas. Reg. § 1.72-9 (1967), would be $91,000.00 (18.2, life expectancy multiple, x $5,000). If the same annuity contract is purchased from an obligor, which issues such contracts from time to time, the value of the obligor’s promise, using the Tables in Rev. Rul. 62-137, and Rev. Rul. 62-216 would be $67,630.00 (13.526, life expectancy multiple, x $5,000). If the transaction is a purely private one, then the value of the obligor’s promise, using Table 1 of the estate tax valuation tables of Treas. Reg. § 20.2031-7(f) (1967) would be $56,684.50 (11.3369, life expectancy multiple, x $5,000). As may be seen from this illustration the variation in these valuations is a consequence of different actuarial multiples being used in each case. This is based on the fact that there is a greater assurance that the annuity contract will be performed when it is issued by a commercial, or quasi-commercial, obligor than when it is issued by a private obligor. Moreover, experience shows that persons who purchase commercial annuities have a longer life expectancy than the general public, i.e., the average purchaser of a private annuity. See Dix v. Commissioner, 392 F.2d 313, 315-17 (4th Cir. 1968).

Interestingly, from the obligor’s standpoint, one must look to a new set of rules in order to determine the obligor’s basis in the annuity contract, for purposes of determining his depreciation deductions if the property is depreciable, and the amount of a gain or loss upon disposition. Typically, he has not been permitted to adopt the commercial valuation rates of Treas. Reg. § 1.72-9 (1967), which would give him a higher de-
nue Ruling 69-74 simply takes this projected gain and divides it by the annuity period. A part of the gain, therefore, will be recognized annually from the very first year that the annuity payments begin. This capital gain part, together with the excluded portion, is charged as an` depreciation deduction, and the potential of less gain or more loss, as the case may be, on the sale of property (Dix v. Commissioner, 392 F.2d 313; Rev. Rul. 55-119, 1955-1 Cum. Bull. 352), but rather he has been restricted to using the lower estate and gift tax valuation tables, Treas. Reg. §§ 20.2031-7, §§ 25-2512-5 (1967). This will thereby reduce the potential depreciation deductions, as well as lower his initial basis for determining gain or loss upon sale of the property. While, as stated above, Rev. Rul. 67-39 covers the income, estate, and gift tax problems with respect to annuities issued from time to time, it would appear that Rev. Rul. 55-119 would still apply to such an obligor in so far as his basis for depreciation and disposition of the property transferred is concerned, since the Rulings and Regulations have consistently drawn a distinction between valuation from the annuitant's, and valuation from the obligor's standpoint. Moreover, neither Rev. Rul. 67-39, nor Rev. Rul. 62-216, upon which it is based, purport to deal with the obligor's side of the transaction.

If survivorship rights exist under an annuity contract, the value of which are includible in the decedent's gross estate, under § 2039 of the Int. Rev. Code of 1954, the valuation to be placed upon these rights will depend upon the nature of the obligor involved. Treas. Reg. § 20.2039-1(c) (1958); Treas. Reg. §§ 20-2031-1, -7, -8 (1967); Rev. Rul. 67-39, 1967-1 Cum. Bull. 18. The amount includible in the decedent's gross estate would be highest where a commercial obligation is involved, and would decrease in amount, depending upon whether the obligor issues such contracts from time to time or is truly private. Insofar as gift tax is concerned, which, for the private annuity, adopts tables that are identical to the estate tax valuation tables (Treas. Reg. § 25.2512-5 (1967)), valuation in order to determine the presence of any gift element will, again, depend upon the type of obligor involved. Treas. Reg. § 25.2512-5 (1967), -6 (1963); Rev. Rul. 67-39, 1967-1 Cum. Bull. 18. See also the discussion of gift and estate tax aspects of annuities infra.

It is interesting to note that in determining the expected return on an annuity contract for the purpose of ascertaining the amount of annual income under § 72 of the Int. Rev. Code of 1954 for both private and commercial annuities, the tables in Treas. Reg. § 1.72-9 (1967) are utilized. Dix v. Commissioner, 392 F.2d 313. Thus, even though these tables are based upon the longer life expectancies of commercial purchasers (Dix v. Commissioner, 392 F.2d at 317), the private annuitant is, nevertheless, required to use them in determining his expected return on the annuity contract rather than being permitted to use a table which reflects his shorter life expectancy. However, where the obligor issues annuity contracts from time to time, the Treasury has deemed it appropriate to prescribe specific tables (Rev. Rul. 62-137 and Rev. Rul. 62-216) to be used for all purposes of valuation with respect to these annuity contracts (Rev. Rul. 67-39, 1967-1 Cum. Bull. 18) and, presumably, this would include determination of the expected return on the contract. Therefore, if it is true that the average purchaser of a private annuity does have a shorter life expectancy than the purchaser of a commercial, or quasi-commercial annuity, a new table, based on this shorter life expectancy, should be issued for the private annuitant, as it has been for the annuitant under a contract from an obligor which issues annuity contracts from time to time.

Further discussion and application of the appropriate valuation principles will be discussed infra in connection with each of the specific situations presented.
against the total annuity payment. The balance of the annuity payment, after deducting the excluded and capital gain portion, will be ordinary income. This immediate capital gain recognition again represents a tightening up of private annuity taxation, since formerly this gain was not recognized until the basis had been recovered. However, since the annuitant's contract investment has also been reduced, the recognition of capital gain income from year one reduces, correspondingly, the amount of the ordinary income portion of the annuity payment. Thus, although the Revenue Ruling does not close out the transaction at the time of the exchange, in the sense that capital gain must be recognized at that time, it has, nevertheless, evaluated the annuity promise, and apportioned a part of the capital gain to each year of the annuity period. In this sense, at least, it is a closed transaction and represents approval of an informal or non-statutory method of reporting income, since an election is not made, and the annuitant is not bound by the rules of Section 453. At the same time, the Ruling is somewhat analogous to the statutory installment method of reporting in so far as it apportions the payments which are allocable to the sale between an excluded return of capital part and a gain part, rather than adopting the original approach of Revenue Ruling 53-239: exclusion up to return of basis, taking account of the gain only afterwards up to the fair market value of the property upon transfer, with any further payments taxable as "interest."

130. 1969 INT. REV. BULL. No. 8, at 9.
131. Id. at 8-9.
132. An informal or non-statutory installment method of reporting income would be to allocate a part of each year's receipts upon a sale of property to principal, in proportion to the amount of anticipated gain, and a part to income. This is in contrast to treating all receipts as principal, or a return of capital, until basis has been recovered, and thereafter reporting further payments as income. Thus, and assuming in these situations that one would be entitled to report a transaction on an open basis, i.e., not to recognize any income until basis has been recovered, the taxpayer, rather, might consider reporting as follows: if property has been sold for $10,000, in which the taxpayer's basis was $5,000, an informal, or non-statutory, method of installment reporting would be to report fifty percent of each year's payments as income, with the balance being a return of capital. Revenue Ruling 69-74, in effect, adopts a non-statutory installment method of reporting the capital gain expected to be realized on the transaction. See, e.g., Victor B. Gilbert, 6 T.C. 10 (1946), acquiesced in, 1946-1 CUM. BULL. 2. See also D. HERWITZ, BUSINESS PLANNING 498 (1966).
133. Two sections (INT. REV. CODE OF 1954, §§ 453(a)-(b)) provide that in sales or other dispositions of real property, and casual sales of personal property exceeding $1,000, the statutory installment method of reporting may be elected, so long as the total payments received in the year of sale do not exceed thirty percent of the selling price.
134. 1969 INT. REV. BULL. No. 8, at 8-9.
The third issue in connection with a private annuity received for property is how to treat any gain realized upon the property over and above its fair market value at transfer. Revenue Ruling 53-239 provided that after the fair market value of the property had been recovered through the payments allocated to the contract investment, any further payments over and above the fair market value of the property received by the annuitant when he outlives his life expectancy would be ordinary income. In contrast to this approach it became arguable under the 1954 Code, in view of the continuing applicability of the exclusion ratio in every year that an annuity payment is received, that this payment would be excludible as a mortality gain. Had cash been paid for the annuity in the same amount as the fair market value of the property actually transferred, excludible mortality gain would have resulted under the present state of the law for payments allocated to the investment in the contract which exceeded the cash investment. Why should this not also be the case when property rather than cash is transferred? This was indefinite under the 1954 Code, but Revenue Ruling 69-74 settles the law. Its position is that the exclusion ratio "is applicable throughout the life of the contract." Payments allocable to the investment part of the exclusion ratio will continue to be excluded, but amounts which finally exceed the anticipated capital-gain, as measured by the difference between the basis of the property and the value of the obligor's promise, are not taxed as capital gain, nor are they deemed to be part of the excludible mortality

135. 1953-2 CUM. BULL. 53, 54.
136. The Internal Revenue Code of 1939 provided in § 22(b)(2) that payments received over and above the annuity investment in the contract were fully includible in income. Thus, once the portion of the annuitant's investment in the contract (under Rev. Rul. 53-239, the fair market value of the property at transfer) had been recovered, it logically followed under the law existing at the time that further payments exceeding that value would be fully includible in income. See, e.g., Hill's Estate v. Maloney, 58 F. Supp. 164 (D. N.J. 1944).
138. Id. This principle assumes that the number of long-lived annuitants will balance the number of short-lived annuitants. Thus, some annuitants will have "mortality gain," which would, in effect, be a tax free windfall, while others will have "mortality loss," which would be a tax detriment by virtue of its non-deductibility.
140. 1969 INT. REV. BULL. NO. 8, AT 9.
gain. Rather, they are to be reported as ordinary income.\textsuperscript{141} These payments are considered to be in the nature of "interest" received upon a sale of property.\textsuperscript{142} While the Revenue Ruling permits the continuing application of the exclusion ratio, it also requires that these payments exceeding the anticipated capital gain be treated as ordinary income. This writer would suggest that these continuing payments are received not on account of a sale of the property but rather because of the annuitant's longevity. Therefore, they may constitute a further excludible mortality gain, not interest.

The clear intent of Revenue Ruling 69-74 is to close out a number of the tax benefits which had existed for the intra-family private annuity. These new restrictions are: a decreased investment in the contract, thereby resulting in a greater proportion of each annuity payment being considered as income; the requirement that capital gain be recognized immediately from the start of the annuity contract, not simply after the annuitant's basis in the transferred property has been recovered; and finally, the requirement that payments over and above the initially anticipated capital gain be included as ordinary income to the extent that these exceed the annual exclusion, analogous to interest received upon a sale of property rather than excluded as mortality gain received under an annuity contract. The Ruling still permits the gain upon the transaction to be treated on a deferred basis, but, interestingly, it values the obligor's promise so that the gain may be recognized as soon as the annuity payments begin.

There is no doubt that the private annuity has reduced the annuitant's income tax liabilities and minimized his estate and gift taxes as well. Revenue Ruling 69-74 is an attempt to eliminate some of the annuitant's tax incentives. Certain aspects of the Ruling appear to be theoretically unsound. First, if the transaction is a genuine sale, the annuitant's investment in the contract should not be his basis in the property transferred, but its fair market value. This is the usual tax rule where property is purchased for other property.\textsuperscript{148} The Ruling,

\textsuperscript{141} Id.

\textsuperscript{142} The approach of Rev. Rul. 69-74 in this respect is analogous to the treatment of a payment in excess of one's investment in the contract under Int. Rev. Code of 1939, § 22(b)(2), with the exception that the exclusion ratio under § 72(b) of the Int. Rev. Code of 1954 continues to apply to the subsequent payments throughout the life of the contract.

by giving the annuitant a substituted basis, is, in effect, analogizing the transaction to a non-taxable exchange since such cases result in a substituted, or carry-over, basis.\textsuperscript{144} Inconsistently, the Ruling does, however, recognize the transaction as a taxable one, modified only in that any gain is deferred over the annuity period rather than taken into account at once. Secondly, once the annuity payments exceed the expected capital gain, as measured at the contract date, this excess is treated as ordinary income, after applying the exclusion ratio. This treatment is objectionable in that this continuation of payments truly is due to the annuitant's longevity, rather than to a sale of property as such.\textsuperscript{145} It should, consistently with the exclusion ratio principle of section 72, be tax-exempt as a mortality gain, attributable to the fact that the annuitant has outlived his actuarial life expectancy rather than taxed as ordinary income as a further gain upon the sale of property.\textsuperscript{146} Similar objections cannot be made against requiring a capital gain recognition from the year one. There is precedent for this.\textsuperscript{147} The real problem is the method of valuing the obligor's promise and deciding upon the valuation table which should be used in this respect: should the same tables which are used to determine the obligor's basis in the property for purposes of his depreciation deductions and gain or loss upon sale of the property\textsuperscript{148} be used for the purpose of determining the annuitant's gain upon the transfer?\textsuperscript{149}

The last vestige of a real income tax advantage on the sale of appreciated property for a private annuity is the deferral of gain, although account must be taken of the gain from the first year. How-

\textsuperscript{144} See, e.g., Int. Rev. Code of 1954, §§ 1035, 1031(d).

\textsuperscript{145} It is only by virtue of the annuitant's continued life that he is entitled to the payments. See notes 133 and 134 supra.

\textsuperscript{146} Id.


\textsuperscript{148} Rev. Rul. 55-119, 1955-1 Cum. Bull. 352 requires the obligor to use the estate and gift tax tables set forth in Treas. Reg. §§ 20.2031-7, -5 (1967), in order to determine his basis for depreciation and for measuring the amount of gain or loss upon a disposition of the property. If the obligor could prove that the use of these tables was arbitrary and unreasonable, then presumably he would be able to substitute a more appropriate valuation table, e.g., one utilized by a commercial life insurance company. Dix v. Commissioner, 392 F.2d 313, 315.

\textsuperscript{149} As stated above, the annuitant's gain upon the transfer of property to a purely private obligor is determined, under Rev. Rul. 69-74, according to the estate tax valuation tables. These valuation tables are also used to establish the obligor's basis under Rev. Rul. 55-119. Thus, an unintentional consistency in the choice of the appropriate valuation table for both the transferor and transferee exists for these purposes.
ever, at least the gain will not be included in the year of transfer when
the annuitant has as yet received no cash with which to pay the tax.

Another dimension to the annuitant's tax posture is whether a loss
deduction may be allowed upon the transfer of depreciated property
in return for an annuity contract. Generally, an annuitant will not be
allowed to deduct a loss upon this transaction since the exchange has
not been considered to be one which was entered into for profit.150
(Should not this rationale now be changed to coincide with Revenue
Ruling 69-74's treatment of excessive payments since the apparent
principle of this treatment is that these are received as a result of a
transaction which was entered into for profit?) This includes the
case of a premature death of the annuitant.151 He is deemed to have
received that which he has bargained for, i.e., payments for the term
of his life. Where the annuitant seeks to establish a loss deduction
upon the original transfer, he should sell the asset to a person other
than the obligor and then invest the proceeds in the annuity
contract.152

It should be understood that since transfer of property for an an-
uuity contract is a disposition, all the rules triggered upon a disposition
of property come into play, including, for example, the recapture pro-
visions of sections 1245153 and 1250154 if the property comes within
either of those classifications.

A gift element may be present in an annuity transfer. A gift in favor
of the obligor would be made where the value of the property trans-
ferred exceeds the value of the expected payments.155 This was the situa-
tion in Revenue Ruling 69-74. On the other hand, there may be a
gift to the annuitant if the actuarial life, and concomitant value of the
promise to pay the annuity, exceeds the value of the property trans-
ferred.156

150. Evans v. Rothensies, 114 F.2d 958 (3d Cir. 1940).
151. See Industrial Trust Co. v. Broderick, 94 F.2d 927 (1st Cir. 1938), cert. denied,
304 U.S. 572 (1938).
152. In selling the property, care should be taken not to sell it to a "related person,"
within the meaning of Int. Rev. Code of 1954, § 267(b), which would cause an other-
wise permissible loss deduction to be disallowed.
154. Id. § 1250. It may be noted that recapture under § 1250 is not complete, but
covers only those cases where the taxpayer has taken depreciation deductions with
respect to depreciable real property on an accelerated basis and has disposed of the
property within 120 months from the date of purchase.
155. Estate of Koert Bartman, 10 T.C. 1073 (1948).
156. For this kind of situation, see Rev. Rul. 55-388, 1955-1 Cum. Bull. 233 (charitable
obligor).
A caveat in connection with control over the transferred property is pertinent at this point. While the retention of a security interest in the property may cause adverse estate tax consequences to the annuitant,\textsuperscript{157} (as discussed below), it may be damaging from an income tax standpoint as well. Under certain circumstances what appears to be an annuity may rather be treated as a trust.\textsuperscript{158} If this is the case, the retention of dominion and control over the transferred property may cause both the current income, as well as capital gains, to be taxed to the grantor.\textsuperscript{159} Moreover, the trust question aside, when the transferor has retained a security interest in the property transferred there is also the risk that the transaction will be treated as a sale on an installment basis, rather than as an annuity transaction.\textsuperscript{160} Under these circumstances, unless the annuitant complies with section 453\textsuperscript{161} as to the maximum down-payment in the year of sale (not more than thirty percent of the selling price)\textsuperscript{162} and files an election to have the transaction treated on an installment basis,\textsuperscript{163} he may have to recognize the entire gain in the year of sale, the disposition being treated on a closed transaction basis.\textsuperscript{164} In the true annuity, the annuitant must have genuinely sold the property to the obligor, retaining no legal interest, even for security purposes,\textsuperscript{165} or equitable or beneficial ownership over

\begin{itemize}
  \item 160. The rationale for the open transaction approach for private annuities is the risk inherent upon the obligor's unsecured and unfunded promise. Where a security interest has been retained in the property transferred, the transaction appears more analogous to the usual commercial sale on credit, in which the seller retains a security interest in the property for the unpaid balance. Since the private annuity is admittedly a bona fide sale, it may easily be deemed to be a sale on an installment basis, rather than an unsecured private annuity disposition in cases where the transferor has minimized the risks of the disposition by retaining a security interest in the property. Under such circumstances, it is not unlikely that the Internal Revenue Service may attempt to characterize the transaction as a sale on an installment basis rather than as an open private annuity transaction.
  \item 162. \textit{Id.} § 453(b).
  \item 163. \textit{Id.} §§ 453(a), (c); Treas. Reg. §§ 1.453-1(a)(1) (1966), -7(a) (1963), -8(a).
  \item 164. \textit{But see} Mamula v. Commissioner, 346 F.2d 1016 (9th Cir. 1965), the taxpayer had originally treated the sale on an open transaction basis, but this was subsequently disallowed. The court held that he might amend his return for the year of sale in order to elect § 453, rather than, alternately, being required to treat the sale on a closed transaction basis, once the open transaction method had been disallowed.
the property.166 The nature of the relationship in a private annuity must be that of debtor-creditor, with the latter being unsecured.167 After the contract has been entered into, a disposition of the property by the obligor should be of no concern to the annuitant. The very premise for deferring the recognition of gain is that the obligor’s promise to pay is personal, not chargeable against, nor secured by the transferred property, nor determinable in amount by reference to the income from the transferred property.168

Charitable Annuities

For many years, persons holding appreciated property have been able to enter annuity arrangements with a charitable organization and enjoy the tax benefits of a private annuity as well as gain the distinct advantages of a charitable contribution deduction if the property or money transferred to the charity exceeds the value of the anticipated annuity. This is the usual case since the cost of a charitable annuity typically exceeds that which would be paid for a commercial one and the dominant reason for the charitable annuity is to obtain a contribution deduction as well as to receive the annuity itself. Moreover, a charitable annuity’s higher cost is due to the fact that the normal charity does not issue a large number of annuity contracts, which would thus enable the actuarial risk factor to be spread over a considerable number of contracts, as is true for a commercial insurer. Again, because of the gift element, it is contemplated that the charity will retain a substantial portion of principal, unlike the commercial annuity which contemplates that both interest and principal will be paid out.

As with the family annuity, the open transaction doctrine had been applied to exchanges of property to a charity in return for a promise to pay an annuity.169 Again, the annuity commitment was theoretically uncertain. However, as a result of an increased use of charitable annuities, the Internal Revenue Service reversed its position in Revenue

v. United States, 35 F.2d 982 (Ct. Cl. 1929); Tips v. Bass, 21 F.2d 460 (W.D. Tex. 1927).


169. There does not appear to have been litigation on this specific point, and the Internal Revenue Service expressed its approval of the open transaction doctrine in a letter ruling on September 9, 1953, 4 P-H 1956 Fed. Taxes ¶76,312.
Ruling 62-136\textsuperscript{170} and established a different principle for charities which issue annuities "from time to time." In such a case, where the value of the annuity contract exceeds the transferor's basis in the property exchanged, he must recognize an immediate gain upon the transfer.\textsuperscript{171} Such a contract therefore is equated to the commercial rather than to the private annuity for the purpose of determining when gain will be recognized.\textsuperscript{172}

The theory behind Revenue Ruling 62-136 is that where a charitable organization issues annuities "from time to time," it closely resembles a commercial organization in this respect. The scope of the Ruling is uncertain. It would obviously include at least those charities which have a clear and definite program of issuing annuity policies in return for substantial gifts.\textsuperscript{173} The annuitant's cost or investment in these cases is considered to be the fair market value of the annuity, as determined by tables established in Revenue Ruling 62-137\textsuperscript{174} and Revenue Ruling 62-216.\textsuperscript{175} The multiples used by these tables are intermediary between those under sections 72 and 2031 and 2512.\textsuperscript{176} Since the "semi-private" charitable annuity transaction has been closed out, the annuitant could not be given a substituted basis to represent his investment in the contract since his gain upon the exchange has already


\textsuperscript{172} \textit{Id.} The valuation of the charity's promise is, however, lower than that of a commercial obligor (but higher than that of a purely private obligor). \textit{See note 129 supra} and accompanying text.

\textsuperscript{173} The more regular the program, the more closely the charity begins to resemble a commercial insurer regularly engaged in the business of issuing annuity contracts. Where the charity does not issue annuity contracts from time to time, the same principles which govern the private annuity would be applicable. \textit{See also} Ross, \textit{The Private Annuity as a Tax Minimizing Instrument}, 41 \textsc{Taxes} 199, 212 (1963).


\textsuperscript{175} 1962-2 \textsc{Cum. Bull.} 30. Rev. Rul. 67-39, 1967-1 \textsc{Cum. Bull.} 18, requires that these tables be used in connection with all estate, gift, and income tax purposes with respect to such annuity contracts, as well as for purposes of § 72. \textit{See also note 129 supra.}

\textsuperscript{176} Treas. Reg. §§ 1.72-9, -7, -5 (1967). For an illustration of the disparity between the multiples used by these tables, \textit{see note 129 supra.}
been taken into account. The substituted basis investment principle established by Revenue Ruling 69-74 would apply only to the intra-family exchange or other dispositions for an annuity which are treated on an open transactional basis, the gain recognition being deferred over the contract period.

Where the fair market value of the property transferred for the charitable annuity exceeds the actuarial value of the annuity, there would be a charitable gift to that extent.177 Thus, the adverse effect of immediate income recognition upon transfer in the semi-private charitable annuity is mitigated by the value to the transferor of the charitable contribution deduction which he will obtain in the year of the transfer.178 The higher his tax bracket, the greater the tax savings generated by the charitable contribution deduction.179

The charitable annuity also may offer an additional benefit with respect to certain kinds of property. Thus, for example, while the sale or redemption of "section 306" preferred stock180 will require that the amount realized be included in income at ordinary rates,181 this result may be avoided, and a charitable contribution deduction in the full amount of the fair market value of the stock, less the value of the annuity, be obtainable as well if the stock is transferred to a charity in exchange for an annuity.182 Moreover, since section 306 preferred stock is most often non-voting, its contribution will not, under such circumstances, reduce the donor's corporate control.183 The charitable annuity also is useful in connection with appreciated property having a low tax basis in the taxpayer's hands, which would generate a recapture of

178. This possibility also points up the importance of transferring appreciated property rather than cash to a charity, since the donor is able to deduct the fair market value of the property (in this case, reduced by the value of the charity's annuity contract), rather than being limited in his deduction by his basis in the property.
179. E.g., a $10,000 gift to a charity by a person in the seventy percent tax bracket will result in a $7,000 tax savings, thereby actually costing him out-of-pocket only $3,000, rather than $10,000 in order to make the gift. Conversely, for a person in the thirty percent tax bracket, a gift of $10,000 to a charity will result in a tax savings of only $3,000. For further discussion of charitable annuities see note 252 infra.
180. INT. REV. CODE OF 1954, § 306(c).
181. Id. § 306(a).
183. Indeed, one purpose of creating a class of preferred stock in a close corporation is very often to allow the owners to make lifetime gifts of that stock (thereby also reducing their taxable estates) while still maintaining their proportionate control in the corporation. See generally 1 F. O'NEIL, CLOSE CORPORATIONS § 2.15, at 66-68 (1958, Supp. 1969).
ordinary income were it sold at its then fair market value.\textsuperscript{184} This recapture may be avoided, although the amount of the charitable contribution deduction would be reduced by the amount which would have been recaptured under sections 1245 or 1250, had the property been sold instead of donated to charity.\textsuperscript{186}

One final point should be noted with respect to the charitable annuity. Should the charity subsequently sell the property which it has received in return for the annuity promise, a gain upon this disposition will not be charged back to the donor unless there was a prior commitment by the charity to dispose of the property after the transfer on behalf of the donor.\textsuperscript{186} If such an agreement exists, the sale will be attributed to the donor.\textsuperscript{187} This situation arose originally in connection with the so-called "Pomona College Plan," under which the College, pursuant to a prior commitment sold appreciated property which had been transferred to it—the transferor having received the benefit of a tax deduction for the full fair market value of the property transferred—and reinvested the proceeds in tax exempt municipal bonds payable to the donor.\textsuperscript{188} Should an annuity arrangement be worked out along these lines, there would appear to be little doubt that any gain upon sale of the property by the charity would be taxed back to the donor.\textsuperscript{189}

**Tax Status of the Obligor**

The private annuity offers tax advantages not only to the annuitant but to the obligor as well. Principal among these is the ability to take depreciation deductions computed upon a basis which is well beyond the obligor's economic investment. Revenue Ruling 55-119\textsuperscript{180} establishes the principles to govern the position of the obligor not only with respect to the depreciation deduction, but also for the purpose of determining gain or loss upon sale. The Ruling treats his purchase of the transferred property as an acquisition for a price which includes the value of prospective payments.\textsuperscript{191} The final price is left to be adjusted at some later date and dependent upon subsequent events.\textsuperscript{192} This doc-

\begin{itemize}
\item \textsuperscript{184} Int. Rev. Code of 1954, §§ 1245, 1250.
\item \textsuperscript{185} Id. § 170(e).
\item \textsuperscript{187} Id. at 204.
\item \textsuperscript{189} Id.
\item \textsuperscript{190} 1955-1 Cum. Bull. 352.
\item \textsuperscript{191} Id. at 353.
\item \textsuperscript{192} Id.
\end{itemize}
trine has also received judicial sanction.\textsuperscript{193} It means that from the transferee's side the private annuity exchange is akin to a closed transaction. While the obligor has the initial advantage of an inflated basis, the adverse aspect of treating his continuing payments as being in the nature of capital expenditures going to constitute the final purchase price\textsuperscript{194} is that no part of the payments may be considered to be interest and thus deductible.\textsuperscript{195}

Taking up first the matter of the depreciation deduction, Revenue Ruling 55-119 establishes the following basis for depreciation: the discounted value of the prospective annuity payments increased by any actual payments exceeding this value.\textsuperscript{196} The Revenue Ruling uses the gift and estate tax regulations in order to determine the value of the prospective annuity payments.\textsuperscript{197} This value is lower than that which would be set for a commercial annuity,\textsuperscript{198} and the courts have specifically rejected the contention that the current value of a promised private annuity should be equated to the price which would be charged by a commercial insurer for a similar annuity.\textsuperscript{199} While the valuation of the committed annuity obligation is thus not as high as the obligor would otherwise wish it to be, nevertheless he does have the ability to take depreciation deductions based upon the value of payments yet to be made. Maximizing depreciation deductions with a relatively low equity investment, thereby generating disproportionate tax benefits, has always been an important part of tax planning.\textsuperscript{200} The existence of this advantage with respect to the private annuity makes it particularly attractive to the obligor. As a result, he is able to derive tax benefits through depreciation deductions which are well beyond his initial nominal investment in the contract.\textsuperscript{201}

\begin{itemize}
\item \textsuperscript{193} See, e.g., Dix v. Commissioner, 392 F.2d 313; Kaufman's Inc., 28 T.C. 1179 (1957).
\item \textsuperscript{194} See, e.g., Kaufman's Inc., 28 T.C. 1179 (1957); Rinehart Farms, Inc. v. United States, 59-1 U.S. Tax Cas. ¶9173 (S.D. Iowa, 1958).
\item \textsuperscript{195} See, e.g., Kaufman's Inc., 28 T.C. 1179.
\item \textsuperscript{196} 1955-1 Cum. Bull. 352, 353-57.
\item \textsuperscript{197} Treas. Reg. §§ 25.2512-5, 20.2031-7 (1967). These tables are identical.
\item \textsuperscript{198} See note 129 supra.
\item \textsuperscript{199} Dix v. Commissioner, 392 F.2d 313 (4th Cir. 1968), places the burden on the taxpayer to prove that the use of these tables is arbitrary and unreasonable.
\item \textsuperscript{200} See, e.g., Crane v. Commissioner, 331 U.S. 1 (1947); Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950); Abraham Teitelbaum, 33 P-H Tax Ct. Mem. ¶64,141 (1964).
\item \textsuperscript{201} The depreciation deductions for the first few years of the contract may exceed the obligor's investment in the contract. Thus, there is a total disproportionality between his investment, on the one hand, and the amount of his depreciation deductions and resultant tax benefit, on the other.
\end{itemize}
life, the depreciation basis subsequent to the annuitant's death will be the total of the annuity payments actually made under the contract. 202

Where both depreciable and non-depreciable property are acquired in return for the annuity, an allocation between the two must be made for the purpose of computing the basis for the depreciable portion of the property. 203 This allocation will be made in accordance with the ratio of the fair market values of the respective properties at the time of the exchange. 204 Where a gift element is present, there will be a substitution of the annuitant's basis proportionately, representing the gift portion of the property transferred. 205

Revenue Ruling 55-119 also establishes rules to determine the tax consequences of a sale or exchange of property which was received in return for the annuity promise. If the annuity is one for life and a disposition is made while the annuitant is still living, the basis for determining gain will be the total annuity payments made up to the date of disposition plus the value, under the gift and estate tax regulations, of the payments which remain to be made for the life of the annuitant. 206 The basis for determining loss, on the other hand, is the total of the annuity payments actually made up to the time of disposition. 207

In any of the preceding cases, when the property transferred under a life annuity has been disposed of by the obligor during the annuitant's life, some adjustment must be made upon the annuitant's death and consequent termination of the contractual obligation. If, when the annuitant dies, the total annuity payments made under the contract have finally exceeded the basis which was used for determining the gain or


203. Id. This is consistent with the tax rule that only property used in a trade or business or held for profit may be depreciated. Therefore, if the obligor has received both kinds of property in the annuity transaction, he must, accordingly, make an allocation of his cost basis between the two.


205. INT. REV. CODE OF 1954, § 1015(a). If the transfer involves a bargain purchase, i.e., partly a gift to the extent of the excess of the fair market value of the property transferred over the present value of the annuity, then the obligor's basis would be lower than it would be in a straight sale, but higher than it would be in a straight gift. In the former case his basis would be a cost one, as computed according to Rev. Rul. 55-119 and INT. REV. CODE OF 1954, § 1012. In the latter case, his basis would be a substituted one according to Rev. Rul. 55-119 and INT. REV. CODE OF 1954, § 1015; see also, e.g., INT. REV. CODE OF 1954, §§ 1035, 1031(d). In the bargain purchase, his basis represents a combination of the two.

206. 1955-1 CUM. BULL. 352, 354.

207. Id.
loss upon its disposition, these excess payments will constitute de-
deductible loss to the obligor in the year, or years, when paid. Where a
loss was originally recognized upon disposition of the property made
during the annuitant's life, this loss is increased by all further payments
made after the disposition of the property. Conversely, where there
has been a gain upon disposition of the property during the annuitant's
lifetime—comparing the obligor's basis, which consists of payments
made up to that time and the value of prospective payments, with the
amount realized—if the total annuity payments ultimately made are
less than the value of the payments that it was projected he would pay,
the difference will be income to the obligor in the year of the an-
nuitant's death. Sale of the property, coupled with the annuitant's
premature death, can, therefore, create a serious tax burden for the
obligor in the year of the annuitant's death. Of course, where the
property is not sold during the annuitant's lifetime, followed by his
premature death, adverse income tax consequences will not result.

The obligor may hold the transferred property for the annuitant's
life and then finally sell it after the annuitant's death. Under these
facts, the basis for determining gain or loss is simply the total annuity
payments actually made under the contract. This will also be the
obligor's basis for depreciation in the years following the annuitant's
death. However, it must be recalled that the obligor has been taking
depreciation deductions from the beginning of the annuity contract
based upon the value of prospective payments, which, it turns out, he never had to make. He has thus received something of a tax benefit

208. Id. at 354-55.
209. Id.
210. Id.

211. One way by which the obligor might prevent immediate income recognition
upon the annuitant's premature death, where he has sold the property during the an-
nuitant's life, would be to provide for the sales price to be made on a deferred basis,
or by providing that payments would be placed in an escrow fund to be made avail-
able to the obligor over a number of years, rather than at one time in a single lump
sum. See Harold W. Johnston, 14 T.C. 560 (1950); William O. Anderson, 30 P-H Tax

212. As stated above, the obligor's cost in the property will become final at the an-
nuitant's death, being the total of the annuity payments made over the life of the an-
nuitant. This will then be the obligor's basis for depreciation, and for determining gain
or loss should he sell the property in the years following the annuitant's death.

214. Id. at 354-55.
windfall. However, this is not recaptured other than by giving him a reduced basis for depreciation in these later years.\footnote{215}

**Gift and Estate Tax Aspects of Annuities**

*Gift Tax*

A major motive for the private annuity may be to make at least a partial gift to the obligor.\footnote{216} On the other hand, the obligor may intend a gift to the annuitant by undertaking a commitment which has a much greater actuarial value than the value of the property which is being transferred to him.\footnote{217} A gift in connection with an annuity policy also may exist between the annuitant and a third party; for example, an annuity contract may be purchased for another as a gift.\footnote{218}

Basically, annuities are treated as any other property for gift tax purposes. Since gift tax liability is predicated upon an outright donative transfer, or a bargain sale, \textit{i.e.}, receiving back much less than the value of the property transferred, we must, in such a case, once again concern ourselves with valuation of the annuity payments.

Valuation for gift tax purposes depends upon the nature of the obligor. In the case of a commercial annuity, the value of the gift is the excess of the property transferred over the value of a comparable commercial contract.\footnote{219} However, it is unlikely that there will be a gift in a commercial situation since there is, in these cases, an intention to exhaust the value of the transferred property prior to death. On the other hand, a private annuity may well involve a partial gift based upon a bargain purchase by the obligor. Unlike the income tax aspect of the private annuity, which treats the exchange from the annuitant’s standpoint on an open transaction rather than a closed basis for purposes of recognizing gain upon the property transferred,\footnote{220} the transaction is, for gift tax purposes, treated on a closed basis.\footnote{221} The value of the annuity payments is determined according to the tables set forth in Trea-
Where the value as computed under these tables is less than the value of the property transferred for the annuity, there would be a gift to the obligor as a result of the bargain purchase to that extent. The promise to make the annuity payments is deemed to be capable of ascertainable measurement at the date of the contract so far as the gift tax is concerned. This had been the situation prior to Revenue Ruling 69-74, and continues to be under Revenue Ruling 69-74, which now makes this assumption for income tax purposes as well.

In contrast to a gift by the annuitant to the obligor, a gift may be made by the obligor to the annuitant where the value of his annuity promise, for gift tax purposes, exceeds that of the property transferred.

A gift to the obligor may require an adjustment in basis. The obligor's basis in the contract where there has been a gift to him is the same as the annuitant's basis in the property transferred, except that for the purpose of determining loss, the basis would be the fair market value of the property at the date of transfer where this is lower than the substituted basis. If the transfer were partly a gift (the bargain purchase) the obligor's basis will be made up in part of the value of prospective payments (described above) and in part by the transferor's (a substituted) basis. From the transferor's standpoint, where he has made a gift to the obligor, presumably after Revenue Ruling 69-74, his basis in the contract will not be affected since under the Ruling he has a substituted basis in the contract rather than a fair mar-

223. Id. § 25.2512-8 (1958); see Estate of Koetz Bartman, 10 T.C. 1073 (1948); May Rogers, 31 B.T.A. 994 (1935), aff'd, 107 F.2d 394 (2d Cir. 1939).
225. Id.
228. Rev. Rul. 55-119, 1955-1 Cum. Bull. 352, 356; INT. REV. CODE OF 1954, § 1015 (a). Where the donor has paid a gift tax with respect to the transfer, the basis of the donee, (or specifically herein the obligor), would be increased by the amount of gift tax paid with respect to such gift but not above the fair market value of the property at the time of the gift. Id. § 1015 (d).
229. Id.
230. See the discussion of the tax status of the obligor supra.
ket value basis. Prior to Revenue Ruling 69-74, in the gift situation, the transferor's basis would have been lowered to the extent that he had made a gift to the obligor.232 This would have resulted, as does Revenue Ruling 69-74 for the intra-family annuity, in higher taxable income to the annuitant due to the lowering of his investment in the contract.

It also is interesting to note that even where the value of the proposed annuity payments is less than the value of the property transferred, if there was an arm's-length exchange in the ordinary course of business, the transaction may be deemed to be a sale rather than a gift,233 which would have resulted in a gift tax liability. This is the old contract adage that one gets what one bargains for, despite values. Thus, assuming a bargain, the respective values exchanged become unimportant. This was the situation presented in *Eva B. Hull.*234 The taxpayer had assigned her one-half interest in oil leases to Hull Enterprises Corporation in consideration of the corporation's promise to pay her an annuity of $15,000 for as long as she lived. Even though the value of the lease was greater than the consideration received in the form of an annuity, the Tax Court held the transaction to be a bona fide sale in the ordinary course of business and not a taxable gift.235 The court in reaching this decision followed the reasoning set forth in *Estate of Monroe D. Anderson:*236

The pertinent inquiry for gift tax purposes is whether the transaction is a genuine business transaction, as distinguished, for example, from the marital or family type of transaction

232. Cf. Rev. Rul. 53-239, 1953-2 CUM. BULL. 53 for the arm's-length intra-family private annuity which did not involve a gift element; the transferor was entitled to a fair market value basis. The apparent theory behind this approach was that since the transfer was an arm's length one, the transferor's basis in the contract must have been equal to the fair market value of the property transferred. See United States v. Davis, 370 U.S. 65 (1962). In the non-taxable situation, which, of course, would include a donative transfer, the usual tax rule is that the transferor would take a substituted basis. See Int. Rev. Code of 1954, § 1015; see also, e.g., Int. Rev. Code of 1954, §§ 1031 (d), 1035.


234. Id. See also E. H. Stewart v. United States, 63-1 U.S. Tax Cas. ¶12,141 (D. Col. 1963), where the jury found that a transfer of ranch property in consideration of the transferee's promise to pay the transferor $7,500 a year for twenty years or until his death, was a bona fide sale and not a gift to the obligor, even though the fair market value of the property was $100,000 and the present value of the right to receive $7,500 per year for the life expectancy of the transferor, age 66, was $68,970.00.

235. 21 T.C.M. at 1079-80.

236. 8 T.C. 706, 720 (1947).
involved in Wemyss and its companion case, Merrill v. Fahs [45-1 USTC ¶ 10,180], 324 U.S. 308. Surely it will not be said that there may not be a genuine business transaction not directly connected with the taxpayer's trade or business or even though the taxpayer be not engaged in "carrying on any trade or business," within the scope of that term as limited by Higgins v. Commissioner [41-1 USTC ¶ 9233], 312 U.S. 212. Bad bargains, sales for less than market, sales for less than adequate consideration in money or money's worth are made every day in the business world, for one reason or another; but no one would think for a moment that any gift is involved, even in the broadest possible sense of the term "gift".237

An annuity may be purchased as a gift for another.238 In that case if the gift is of a present interest, as an immediate annuity payable to the donee, the donor would be entitled to the benefit of the annual exclusion: $3,000 per year per donee,239 and for gifts to a spouse, $6,000 per year by virtue of the gift tax marital deduction.240 Further, a gift by a husband and wife acting together also may double the amount of the exclusion since they may elect to have the gift treated as if made one-half by each of them instead of as if made by one alone.241 In addition to the annual exclusion of $3,000 per donee, the donor has a lifetime exemption of $30,000.242 Therefore, should a gift exceed the annual exclusion, gift tax liability will not result if the excess is charged against the lifetime exemption.243 Gifts of future interests, as where the donee has no present right to receive the cash value of the contract, are not entitled to the benefit of the annual exclusion,244 but do come under the lifetime exemption.245 Where one purchases outright an annuity policy for another, the amount of the gift is the value of the right to receive the payments in the future.246 When the

237. 21 T.C.M. 1080.
240. Id. § 2523.
241. Id. § 2513.
242. Id. § 2521.
243. Cf. id. §§ 2503(b), 2521.
244. The donee must have the present right to use, possess, or enjoy the property. Id. § 2503(b); Treas. Reg. § 25.2503-3 (1958).
premiums are paid over a period of time, there is a gift in the amount of the annual premiums.\textsuperscript{247} In a survivorship annuity, there is a gift measured by the amount by which the total premium paid for the contract exceeds the premium which the donor would have paid for a single life annuity.\textsuperscript{248} So where one purchases a joint and survivor annuity with his wife, he makes a gift to her of her share of the payments on such a contract.\textsuperscript{249} Another form of gift in connection with an annuity would be a transfer by the annuitant of the contract to another, \textit{i.e.}, giving his rights under the contract to another.\textsuperscript{250} If an annuity has been purchased for another as a gift, should the annuitant die before receiving the full anticipated benefits under the contract, a loss deduction will not be allowed to the person who has acquired the annuity.\textsuperscript{251}

As previously discussed, if the transferee is a charity, the value of the gift is deductible. Thus, for a higher bracket annuitant, while the investment in the contract may be lower, the amount of the deduction may have more value when taken at the time of the exchange, while the lower investment in the contract will yield income in later years when his bracket presumably will be lower.\textsuperscript{252}

\textbf{Estate Tax}

The Federal estate tax captures property that is transferred at death.\textsuperscript{253}


\textsuperscript{249} The husband would have the benefit of a marital deduction, as provided in \textsc{Int. Rev. Code of 1954}, § 2523(a), for one-half of the value of the gift, assuming that her interest qualifies for the deduction. \textit{See id.} § 2523(b).


\textsuperscript{251} White v. United States, 67-1 U.S. Tax Cas. ¶ 9230 (N.D. Tex. 1967). This follows the usual rule that one is not allowed a loss deduction where he dies before his actuarial prediction. In such a case he is deemed to have received what he bargained for, \textit{i.e.}, payments for his life, short-lived though it may be. \textit{See Industrial Trust Co. v. Broderick, 94 F.2d 927 (1st Cir.), cert. denied, 304 U.S. 572 (1938).}

\textsuperscript{252} This may be illustrated by an example. \textit{Taypayer A, who is in the seventy percent bracket transfers property to a charity in return for an annuity. The value of the property exceeds the value of the charity's annuity contract (as determined under Rev. Rul. 62-136, 1962-2 \textsc{Cum. Bull.} 12; Rev. Rul. 62-137, 1962-2 \textsc{Cum. Bull.} 28; Rev. Rul. 62-216, 1962-2 \textsc{Cum. Bull.} 30; Rev. Rul. 67-39, 1967-1 \textsc{Cum. Bull.} 18) by $100,000. The tax benefit to A, \textit{i.e.}, the tax savings resulting from this excess, will be $70,000. During the years of the annuity contract A may be in a much lower income tax bracket, such as thirty percent, which means that the ordinary income portion of each annuity payment, after deducting the excludible and capital gains portions, will be taxed at only thirty percent.

\textsuperscript{253} \textsc{Int. Rev. Code of 1954}, § 2033.
An annuity with a survivorship feature may result, therefore, in the value of the survivorship right in proportion to that part of the purchase price which was paid by the decedent,254 being included in the primary annuitant’s gross estate since the right is not transferred until death.255 The beneficiary’s rights to enjoyment are suspended until then. On the other hand, a single life annuity with no survivorship rights transfers nothing at death, since all the annuitant had was an enforceable right during his lifetime to the annuity payments which terminated at his death. In the annuity with right of survivorship, the amount includible in the decedent’s gross estate is the present value at the date of death of any amounts receivable by the beneficiary (or beneficiaries), by reason of his surviving the decedent, under a contract or agreement.256 The contract need not be formal in nature and includes any arrangements, understandings, plans or similar combinations which establish survivorship rights.257

Section 2039 is the governing estate tax statute.258 It provides that the gross estate includes the value of an annuity or other payment receivable by the beneficiary if under a contract or agreement an annuity or other payment becomes payable to a beneficiary by reason of his surviving the decedent.259 The decedent may have possessed the right to receive such an annuity or payment either alone or in conjunction with another for his life or some similar period.260

Since the annuity must have been either payable to the decedent or he must have possessed the right to receive it, it has generally been held that where the decedent or the beneficiaries have a mere expectancy to payments the annuity will not be included in the estate.261 The distinguishing factor may depend upon whether the rights of the annuitant to receive payments are subject to someone else’s discretion.262 Suppose, for example, that an employer agreed to provide his employee, upon retirement at age 65, with an annuity for life, and then to pay, after the employee’s death, a similar life annuity to his designated beneficiary. The agreement may further provide that no payments would be

254. Id. § 2039(b). See discussion of employee annuities supra.
255. INT. REV. CODE OF 1954, § 2039(a).
257. Id. § 20.2039-1(b)(1).
258. INT. REV. CODE OF 1954, § 2039.
259. Id. § 2039(a); Treas. Reg. § 20.2039-1(a)-(b)(1) (1958).
260. Id.
262. Id.
made if the employee dies before reaching retirement age. If the employee died at age 63, the employer, nevertheless, might decide to pay an annuity to the would-be designated beneficiary although, as a result of the employee's pre-retirement death, the employer was under no contractual obligation to make the annuity payment to the beneficiary. Thus, the decision to provide the beneficiary with an annuity was completely discretionary with the employer, and the value of the payments would not be includible in the decedent's gross estate.\footnote{263}

An annuity is considered to have been payable to the decedent if at the time of death he was actually receiving payments even though he did not have an enforceable right to have them continued.\footnote{264} Thus, in the preceding example, if the decedent's employer contracted to provide him an annuity for life, commencing at age 65, and then to pay a lump sum to a beneficiary, and if the employer had already begun to make payments to the annuitant at age 63, who then died at age 64, the annuity would be considered as payable to him, even though he had no right to force the continuance of these payments.\footnote{265} The decedent also is considered as having possessed the right to receive the annuity payment if immediately prior to his death he had an enforceable right to receive payments at some time in the future, even though he had no present right to receive them.\footnote{266} This would be an enforceable right if the decedent had fulfilled all the conditions precedent to the vesting of the right to enjoyment prior to his death.\footnote{267} But if there is only an intervening interest, and the decedent has otherwise fulfilled his obligations, he nonetheless has the right to receive the income.\footnote{268} This may again be illustrated by an example. An employer may agree, pursuant to a retirement plan, to pay the employee, upon his retirement at age 65, an annuity of $1,000 per year for life, and to pay to the employee's designated beneficiary after his death a similar life annuity. The plan also may provide that (a) should the employee sever his employment before retirement and after his rights have vested, he would in such case have a nonforfeitable right to such an annuity at age 65 as is specified by the terms of the contract, and (b) in the event of death prior to retirement age, a specified lump sum would be payable at that time

\footnote{263.}{Treas. Reg. § 20.2039-1(b) (2), Example (4) (1958).}
\footnote{264.}{Id. § 20.2039-1(b) (1) (1958).}
\footnote{265.}{Id. § 20.2039-1(b) (2), Example (2) (1958).}
\footnote{266.}{Id. § 20.2039-1(b) (1) 1958).}
\footnote{267.}{Id.}
\footnote{268.}{Cf. Int. Rev. Code of 1954, § 2036; see also, e.g., Marks v. Higgins, 213 F.2d 884 (2d Cir. 1954).}
to his beneficiary. Assume that the employee were to die at age 60 and that the lump sum was paid to the beneficiary. This amount would be includible in the employee's gross estate, since under section 2039 he is deemed to have "possessed the right to receive" an annuity. 269 If, in this case, the only permissible condition for separation from employment before retirement was death, the result would be the same so long as the decedent had faithfully followed the contract up to the time of his death. In such a case, "he is considered to have had, immediately before his death, an enforceable right to receive an annuity" commencing at age 65. 270

While the annuity is deemed to be payable to the decedent even though payments have not commenced at the date of his death, the courts have held that the decedent's rights must have been nonforfeitable. 271 Nonforfeitability exists so long as the decedent himself controls the conditions which must be met in order to prevent a forfeiture. 272 The Treasury Regulations further clarify that a forfeiture provision in connection with the beneficiary's interest alone will not defeat the application of section 2039, but may affect the valuation of the beneficiary's interest. 273

Section 2039 does not allow for a reduction in the value of interests which are vested in others at the time of death. The very amount to be considered is the value of the beneficiary's interest that he has by reason of surviving the decedent. 274 The fact that this interest was enjoyed during the decedent's life is immaterial, for it is the continuance by reason of survivorship that is being taxed. The value of the survivor's interest, where a commercial annuity exists, is the fair market value at the date of death, or the alternate valuation date. 275 The value is equated to the cost of other annuities issued by the same company. 276 For a noncom-

269. Treas. Reg. § 20.2039-1(b)(2), Example (3) (1958). See discussion above for the differentiation between an annuity payable to a designated beneficiary and the proceeds of a life insurance policy payable to a beneficiary. In brief, an employee benefit program may provide for an annuity and life insurance as well, or it may simply provide for an annuity with survivorship rights, either in a lump sum or as a continuing payment, to be paid to a designated beneficiary.


272. Id.


274. Id. § 20.2039-1(c).

275. Id. §§ 20.2031-1-7-8 (1967), 20.2039-1(c) (1958).

276. Id. § 20.2031-8 (1967).
mercial annuity, the Treasury Regulations establish a separate valuation table.\(^{277}\)

A limitation is placed upon the amount included in the decedent’s gross estate.\(^{278}\) As stated above, this amount is limited by the portion of the purchase price of the annuity or other contract that was paid for by the decedent.\(^{279}\) Therefore, the amount to be included is only that proportionate amount of the value of the annuity or other payment receivable by the beneficiaries that is attributable to the purchase price contributed by the decedent.\(^{280}\) Thus, if the wife has contributed twenty percent of the purchase price, eighty percent, or the portion contributed by the decedent’s husband, would be included in his gross estate. If, in the case of a joint and survivor annuity for a husband and wife, the husband has paid all the costs of the policy and his wife survives, the entire value of the amounts payable to the wife would be included in the husband’s gross estate. But, under the same circumstances, if it is the husband who survives, nothing will be included in the gross estate of the wife since she made no contributions.

Section 2039 covers the private as well as the commercial annuity. Since a private annuity can be based upon the single life of the annuitant, there will not be an annuity or other payment that is receivable by a beneficiary by reason of surviving the decedent. But, of course, if a joint and survivor clause were included in a private or noncommercial annuity, section 2039 would apply in the same manner as it does to commercial annuities, requiring inclusion of the value of the survivorship interest. The only difference in these cases would be that the valuation of the survivorship right under the private annuity contract would be different than it would be under a commercial annuity.\(^{281}\)

Thus far, we have been concerned with section 2039 which deals specifically with annuities. However, this section should not be of special concern, per se, when the private annuity is considered. It has al-

\(^{277}\) Id. § 20.2031-7.
\(^{278}\) Int. Rev. Code of 1954, § 2039(b).
\(^{279}\) Id.
\(^{280}\) Id.

\(^{281}\) Valuation of the survivorship right under a private annuity is determined according to the tables set forth in Treas. Reg. § 20.2031-7(f) (1967). Valuation of the survivorship right under a commercial annuity is the cost of comparable contracts issued by the company. Treas. Reg. § 20.2031-8 (1967). It should be noted that the values accorded the survivorship right under a private annuity are lower than those of a corresponding commercial annuity. The exact amount of this difference will depend upon the cost of comparable commercial contracts in contrast to the value determined for the survivorship right of the private annuity under the Treasury Regulation tables.
ready been noted that a transfer of property with a retained life interest will cause the fair market value of the property to be included in the decedent's gross estate. One of the estate planning benefits of the private annuity, however, is that it actually transfers the property during life. Thus, the decedent does not own the property at death, although he was actually economically in the same position as if he did. By using the private annuity, he has divested himself of dominion and control over the property, thereby avoiding the estate tax. At the same time he also has availed himself of gift tax exclusions and exemptions, previously discussed, and yet still has retained the benefits of enjoying an income for life.

Ruby Louise Cain is an excellent example of the advantages of the private annuity in practice. The decedent sold her stock in a family-owned corporation to the corporation for $150,000. The corporation agreed to make an initial payment of $6,000.00 at the time of the stock transfer and to pay her $1,000 per month for twelve years or until her death, whichever occurred first. When she died the Commissioner attempted to include the amount still due under the contract, $44,135, in her gross estate under section 2036 of the Internal Revenue Code of 1954, on the grounds that she had made a transfer of the property while retaining a life interest. The Tax Court held that the decedent had "retained neither possession, enjoyment, nor the right to income from the transferred stock" and, therefore, the balance of the purchase price was not included in her gross estate. In reaching this decision the Tax Court followed the reasoning expressed in Fidelity-Philadelphia Trust Co. v. Smith, where the Supreme Court of the United States,
in construing section 811 (c)(1)(B) of the Internal Revenue Code of 1939\footnote{\textit{Int. Rev. Code of 1939, § 811 (c) (1) (B)}.} (the predecessor to section 2036), stated:

Where a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for his lifetime, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent. E.g., Estate of Sarah A. Bergan, 1 T.C. 543, Acq., 1943 Cum. Bull. 2; Security Trust & Savings Bank, Trustee, 11 B.T.A. 833; Seymour Johnson, 10 B.T.A. 411; Hirsh v. United States, 1929, 35 F. 2d 982, 68 Ct. Cl. 508; cf. Welch v. Hall, 1 Cir., 134 F. 2d 366. In these cases the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made.\footnote{\textit{Int. Rev. Code of 1954, §§ 2036, 2039. Cf. also id. § 20.2037-1(e). Example (5) (1958)}.}

If the decedent did not in fact transfer the property until death so that it was retained for life, or for a period ascertainable only with reference to his death, or for a period that did not in fact end before his death, the value of the interest transferred at death would be included in the decedent's gross estate.\footnote{\textit{Int. Rev. Code of 1954, §§ 2036, 2039. Cf. id. § 2037.}} Also, if the decedent died prior to the expiration of a fixed number of years which were clearly beyond his lifetime expectation, the property will be considered to be transferred at death, and includible in his gross estate.\footnote{37 T.C. 185, 188 (1961).} For instance, if an octogenarian created an annuity interest in himself to terminate after fifty years, then to another, it is apparent that the annuity was not designed to last for a term of years but was in fact an annuity for life with transfer upon death to a survivor.

on the theory that the annuity payments which were receivable until death constituted income from property transferred, \textit{i.e.}, the life insurance policies, with a retained life interest in, the decedent within the meaning of § 811(c)(1)(B) of the Int. Rev. Code of 1939 (predecessor to Int. Rev. Code of 1954, § 2036). The Supreme Court held, however, that the proceeds of the life insurance policies were not includible in the decedent's gross estate since the annuity contracts were entirely independent of the life insurance policies. Thus, the annuity payments were income from the annuity contracts, and not from the transferred life insurance policies, in which the decedent had no rights or interest after transferring them.

\begin{itemize}
\item \footnote{37 T.C. 185, 188 (1961).}
\item \footnote{\textit{Int. Rev. Code of 1954, §§ 2036, 2039. Cf. id. § 2037.}}
\end{itemize}
Another problem that may exist in connection with annuities is that created by the "transfer in contemplation of death" rule of section 2035.293 Where property is transferred within three years of death, a rebuttable presumption is raised that the transfer was made in contemplation of death.294 Under section 2035, the value of the property so transferred may be included in the estate unless the donor can prove that the transfer was made for a living motive and not in contemplation of death. Thus, if an annuitant transferred property to the obligor and died within three years thereafter, the value of the property so transferred might be included in the value of his gross estate. There is an escape, however, since the statute excludes transfers made for a full and fair consideration.295 Therefore, if there was truly the exchange contemplated by the private annuity, the property will not be caught in the decedent's gross estate under section 2035. In order to make this determination, an evaluation of the obligor's promise to pay will have to be made. It should be evident that the private annuity will be subject to scrutiny by the courts, for the transfer of property to a close relative, which the private annuity typically involves, would certainly appear to be a transfer made in contemplation of death if the annuitant dies within three years. If the annuitant is at an older age or in poor health, it might be better to sell the property outright, recognizing a capital gain,296 and then purchase the annuity for cash so as to avoid having the value of the property included in his gross estate.

Estate and Gift Tax Reform Proposals

The tax reform proposals which were submitted to Congress early this year would make important changes in present gift and estate taxation.297

293. INT. REV. CODE OF 1954, § 2035 (a).
294. Id. § 2035 (b); Treas. Reg. § 20.2035-1 (d) (1958); see e.g., United States v. Wells, 283 U.S. 102 (1931); Estate of Oliver Johnson, 10 T.C. 680 (1948).
296. INT. REV. CODE OF 1954, §§ 1201, 1202. This would be true if the capital gain tax, a maximum of twenty-five percent of the gain, were less than the estate tax which would have been imposed, i.e., resulted from the property being included in the decedent's gross estate. It must also be remembered that if the annuity is purchased for cash furnished by the decedent, there may not be survivorship rights under the annuity contract; otherwise, their value would be included in the decedent's gross estate.
These also include a revision with respect to the private annuity.\textsuperscript{298} Before considering this specific development, the basic approach of the reform program should be analyzed in detail.

(1) \textit{Taxation of Unrealized Appreciation of Assets Transferred at Death or by Gift.} Present law permits property that has appreciated in value to be transferred at death without the imposition of a tax upon the unrealized appreciation.\textsuperscript{299} Moreover, the transferee receives these assets with a stepped-up basis, \textit{i.e.}, the fair market value at the date of death, rather than with a substituted basis in the property.\textsuperscript{300} Thus, pre-death appreciation completely escapes taxation.

The new proposal would impose a capital gains tax on the unrealized appreciation which is inherent in property transferred at death.\textsuperscript{301} The gain would be reported on the decedent's final income tax return as if he had sold the property just prior to death.\textsuperscript{302} Present capital gains rates, including the fifty percent deduction and the twenty-five percent maximum rate, would be applicable.\textsuperscript{303} This tax would be considered to be a debt of the estate and thus would be deductible from the gross estate of the decedent in determining the estate tax liability, thereby reducing federal estate taxes.\textsuperscript{304} The transferee would take as his basis in the asset transferred the fair market value of the property at the date of death of the decedent.\textsuperscript{305}

The proposal makes certain exceptions, which would either reduce or completely exempt the amount of gain required to be recognized. These include: (a) a basic exemption of $60,000, \textit{i.e.}, unrealized appreciation would be subject to tax only to the extent that it exceeds $60,000, or the decedent's basis, whichever is larger;\textsuperscript{306} (b) personal and household items of less than $1,000 in value would be transferable free of tax;\textsuperscript{307} (c) a one hundred percent marital deduction would be established for inter-spousal transfers\textsuperscript{308} (discussed in more detail below); (d) a limited exemption on transfers to orphans;\textsuperscript{309} (e) a complete exemption

\textsuperscript{298} Id. at 349.
\textsuperscript{299} Id. at 340.
\textsuperscript{300} Int. Rev. Code of 1954, § 1014(a).
\textsuperscript{301} Estate and Gift Tax Proposals, supra note 297, at 340.
\textsuperscript{302} Id.
\textsuperscript{303} Id.
\textsuperscript{304} Id. at 336.
\textsuperscript{305} Id.
\textsuperscript{306} Id. at 342.
\textsuperscript{307} Id. at 342-43.
\textsuperscript{308} Id. at 343.
\textsuperscript{309} Id. at 343-44.
on transfers to charities if the "amount of the interest given to charity can be measured with certainty." \textsuperscript{310} The outright transfer of appreciated property directly to the charity poses no problem; however, where the transferor creates a split-interest, such as a trust to pay the income to A for life with remainder to the X charity, (or vice versa), the gift to the charity will qualify for the exemption only if it meets certain tests, \textsuperscript{311} (f) only appreciation that occurs after the date of enactment (December 31, 1969) would be subject to taxation; \textsuperscript{312} (g) the several provisions under present law which reduce the burden of paying estate taxes, such as sections 303, \textsuperscript{313} 6161, \textsuperscript{314} and 6166, \textsuperscript{315} would be equally applicable to embrace the new capital gain and transfer tax; \textsuperscript{316} (h) gains on assets giving rise to ordinary income transferred at death would be eligible for income averaging to reduce the problem of "bunching;" \textsuperscript{317} and, (i) net unrealized losses on business or investment property would be available to offset capital gains and also could be carried back to the three preceding years to offset ordinary income. \textsuperscript{318}

In order to assure tax neutrality in gratuitous property dispositions, whether inter vivos or at death, any unrealized appreciation in property gifted during life would also be subject to income taxation at the time of the transfer. \textsuperscript{319} Exceptions, corresponding to those mentioned above in the death situation, would be applicable for the living transfer as well. \textsuperscript{320} The imposition of this new tax would necessitate a revision of

\textsuperscript{310} Id. at 344.

\textsuperscript{311} Either the income beneficiary must receive an outright annuity, which provides for an annual payment of a specified dollar amount or a fixed percentage of the fair market value of the property at the time of transfer; or, he must receive a fixed percentage of the fair market value of the property, recomputed annually. This distribution would be made initially out of income and afterwards from corpus. To assure objectivity in the determination of the fair market value of the property transferred, the donor of a lifetime disposition would be subject to a ten year waiver of the statute of limitations with respect to the assessment of the capital gain tax on such a transfer. For testamentary transfers, the determination of fair market value must be made by a disinterested and independent person. Split interest transfers to charities which fail to meet either of these conditions would be subject to tax. Id.

\textsuperscript{312} Id. at 340, 351.

\textsuperscript{313} INT. REV. CODE OF 1954, § 303.

\textsuperscript{314} Id. § 6161.

\textsuperscript{315} Id. § 6166.

\textsuperscript{316} ESTATE AND GIFT TAX PROPOSALS, supra note 297 at 347.

\textsuperscript{317} Id.

\textsuperscript{318} Id. at 341.

\textsuperscript{319} Id. at 348-49.

\textsuperscript{320} Id. at 349.
the present rules of basis found in section 1015.321 Rather than the substituted basis which he now receives, the donee's basis would be increased by the amount of gain recognized by the donor at the time of the transfer.322

As for private annuities specifically, the proposal would change the traditionally open transaction approach used up to now. This would be done for fear that to leave the law as it currently stands, while imposing a tax upon unrealized appreciation in donative transfers generally, would encourage the private annuity as a device to avoid the tax.323 As explained above, under present law the transfer of appreciated property in a private annuity setting does not give rise to the recognition of income to the transferor-annuitant at the date of the transfer. While the Treasury's apprehension may appear to be warranted, it is basically unconvincing. The capital gain tax proposed for donative transfers, lifetime and at death, should not apply here as an objective rule. A better approach would be to review each transfer taking the form of a private annuity to see if it was arranged under the guise of an annuity exchange in order to avoid the capital gain tax which the transferor would pay, under the proposal, upon a donative transfer. Such an approach appears to be fairer and would permit account to be taken of the substance rather than the form of the transaction. If there is a genuine annuity transaction, the rationale which has always justified deferral of recognition of gain upon the transfer, i.e., the essential instability and uncertainty of the private obligor's unsecured promise, continues to hold true. Revenue Ruling 69-74 appears to go far enough in tightening up the taxation of private annuities.

Another objectionable feature of the Treasury's suggested change is its attempt to maximize the amount of gain realized in the private annuity transaction by using the commercial valuation tables,324 rather than the estate tax valuation tables now adopted by Revenue Ruling 69-74, in order to value the obligor's promise. This would give rise to a greater amount realized by the transferor. Obviously, the Treasury is seeking the best of all possible worlds since, presumably, the obligor's basis for depreciation and gain or loss would not be the higher commercial one, but rather still the lower basis which is established under the estate and gift tax regulations.

322. ESTATE AND GIFT TAX PROPOSALS, supra note 297, at 349.
323. Id.
324. Id.
(2) **Unification of Estate and Gift Taxes and Unlimited Marital Deduction.** As mentioned at the beginning of this article, the present gift tax rates favor individuals who are able to make inter vivos dispositions to those who are the natural objects of their bounty and who would take the property in any event upon an intergenerational transfer at death. Present gift tax rates are substantially lower than those of the estate tax. Moreover, this differentiation is bolstered by an annual $3,000 exclusion for gifts to each donee and a $30,000 lifetime gift tax exemption.

In order to eliminate the gift-estate tax disparity, and as a corollary to the principle of taxing unrealized appreciation on property gratuitously transferred during life or at death, the Treasury has proposed that a single unified transfer tax replace the present dual system of gift and estate taxation. Under this new system, a single, cumulative tax would be imposed upon all transfers, regardless of whether made during lifetime or at death. The present $30,000 lifetime gift tax exemption and the $60,000 estate tax exemption would be replaced by one total exemption of $60,000, plus a complete exemption for inter-spousal transfers. The present $3,000 annual exclusion per donee would be retained, to provide “some incentive for making lifetime gifts” as “economically desirable.” A single revised rate schedule would apply to both living and death transfers. The proposed rates would incorporate a general reduction of approximately twenty percent from present estate tax rates. For example, a taxable estate in the $100,000 to $150,000 bracket is presently taxed at a rate of thirty percent, resulting in a tax in the top bracket of $35,700. Under the unified transfer tax, the same estate would be taxed at a rate of twenty-two percent and the amount of tax in the top bracket would be $25,900. The proposed rates would be progressive in nature, but the inordinately steep progression in the

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325. See note 14 supra.
328. Id.
331. Id.
332. Id. at 355.
333. Id. at 368.
334. Id. at 370.
335. Id.
lower brackets under present law would be reduced, and there would be an acceleration of the rate of progression for larger transfers.\textsuperscript{386}

A necessary incident to the unified transfer tax would be the elimination of section 2035, dealing with gifts in contemplation of death.\textsuperscript{387} Since the incentive to make “deathbed transfers,” in order to take advantage of lower gift tax rates, would disappear because a donative transfer would be taxed at the same rates, irrespective of when made, and there would be no further need for this section.\textsuperscript{388}

The proposal also provides that the transfer tax for lifetime gifts would be payable out of the property transferred as is realistically the case for testamentary transfers.\textsuperscript{389} This is accomplished by “grossing-up” the gift, \textit{i.e.}, valuing the gift so as to include the amount of the tax within the amount of the gift upon which the tax is computed.\textsuperscript{390} This will cause the tax to be paid in effect out of the transferred property. A table will be provided to aid the taxpayer in making this calculation.\textsuperscript{391}

The most important of the “excluded transfers”\textsuperscript{392} provided for by the

\begin{itemize}
\item[336.] \textit{Id.} at 355.
\item[337.] INT. REV. CODE OF 1954, § 2035.
\item[338.] ESTATE AND GIFT TAX PROPOSALS, supra note 297, at 361-62.
\item[339.] \textit{Id.} at 369.
\item[340.] \textit{Id.}
\item[341.] \textit{Id.}
\item[342.] Those dispositions which do not result in taxation at the time of the initial transfer are, \textit{e.g.}, gifts and bequests to charities and orphans, gifts which do not exceed $3,000, and interspousal transfers. Other completed transactions which dispose of all or part of the transferor’s beneficial ownership in property are referred to as “included transfers” and are subject to taxation at the time of the initial disposition. The exercise, lapse, release, or termination of a general power of appointment would also be treated as a taxable transfer under the new provisions, as is true under present law. The present rules which impose a gift tax, where a joint interest is created during life in another, to the extent that the value of such interest exceeds any consideration paid by the donee, would generally be retained by the unified transfer tax proposals. In the case of a joint interest with right of survivorship, the value of the survivorship right would also continue to be an included transfer in proportion to the consideration paid by the decedent. As far as what constitutes a completed transfer, in connection with jointly held property, where the joint ownership arrangement permits either of the co-owners unilaterally to withdraw the entire value of the property, \textit{e.g.}, a joint bank account, there would not be a completed gift, and thus, no taxation at the time of the creation of the interest. It should be noted that the unlimited marital deduction would insulate the creation of a joint interest between husband and wife from any adverse tax consequences. The proposals would also include in the gross estate of the decedent the proceeds of a life insurance policy if he was the owner of the policy (as determined under present law) at the date of death.

Presently, employee death benefits under a qualified pension plan, to the extent that such benefits are the result of employer contributions, and are not paid to the employee or his estate, are not included in the employee’s gross estate. The unified transfer tax
proposals is the unlimited marital deduction, which allows a one hundred percent exemption from taxation for interspousal property transfers, whether made during life or at death. If the transfer has been made during life, the property will, however, become part of the transferee’s taxable estate, unless consumed before death. The drafters anticipate that the unlimited marital deduction “will reduce the tax burden in the case of small or medium sized estates, where the property on the death of the husband must usually provide for the widow and children.” A further goal of the change is to allow flexibility in planning transfers between spouses, unaffected by tax considerations.

CONCLUSION

As stated at the beginning of this article, the middle income taxpayer has been the person most adversely affected by the inflation-tax whipsaw. To the extent that this relative unsophisticate in tax doctrine and practice has been benefited by the private annuity, this writer favors a liberalized doctrine to govern the private annuity. Apparently the Treasury believes, however, that the private annuity is at its worst a consummate attempt at tax avoidance: income, gift, and estate as well. Thus, the recent promulgation of Revenue Ruling 69-74 makes the transaction less attractive to the annuitant in several income tax savings respects, and the specific aim of one of the Treasury’s tax reform proposals would be to close out the transaction immediately upon the exchange.

There can be little doubt that the Internal Revenue Code, a superstructure of confusion to most, with its complementary Treasury Regulations (not to mention its accompanying and myriad judicial doctrines) needs reform in numerous respects, and, ideally, a shifting of tax burdens to apportion more equitably the burden of taxation. Utopia would be a combination of tax reform with simplification. This expectancy is held would eliminate this exclusion (except in the case where the spouse was the beneficiary), and the employee would be treated as having made a death transfer to the person receiving the benefits. Id. at 372-84.

343. Id. at 377-81.

344. It is also possible under the proposals to waive the interspousal marital deduction. In some situations, it may be more advantageous to have the property transferred to a spouse taxed at the time of the initial transfer. The transferor, usually the husband and gainfully employed at the time of the disposition, would be better able to pay the transfer tax than would his widow. If property is taxed by election to waive the interspousal marital deduction, it would not be taxed again upon a later transfer to another by the surviving spouse. Id. at 379.

345. Id. at 378.

346. Id. at 358.
out by the concept of a minimum tax on income, regardless of its kind or source. This writer is in wholehearted agreement with these imperatives of tax reform, including reapportionment of the burden of taxation, which progressive taxation has failed to achieve, and tax simplification. Let us not have any revision, however, without adopting the more basic and essential changes which are needed. Until other benefits are made available to the largely unrepresented and heavily taxed middle and lower income taxpayer, such as: increasing the standard and minimum standard deduction, raising the exemption allowance, and granting a deduction or direct credit for family educational expenses, further limitations should not be placed upon the private annuity, as such, at this time. True, the device is available to, and indeed, may no doubt receive much greater use by the wealthy tax-sophisticate. However, as already explained, the private annuity is a relatively simple program with the potential of assisting a much broader base of taxpayers, annuitants and obligors both. To emphasize its advantages, even


349. "Simplicity is the characteristic of a tax which makes the tax determinable for each taxpayer from a few readily ascertainable facts." Surrey & Brannon, Simplification and Equity as Goals of Tax Policy, 9 WM. & MARY L. REV. 915 (1968).


351. Int. Rev. Code of 1954, § 141(c). The minimum standard deduction was enacted in 1964 and provides that the standard deduction shall not be less than $300, plus $100 for each exemption over one. See also House Committee on Ways and Means, and Senate Committee on Finance, 91st Cong., 1st Sess., U.S. TREASURY DEP'T, TAX REFORM STUDIES AND PROPOSALS, LIBERALIZATION OF THE MINIMUM STANDARD DEDUCTION, pt. 2 V-A, at 127 (Comm. Print 1969).


after Revenue Ruling 69-74 as a part of long-range income and estate tax planning: deferral of gain recognition upon the transfer of appreciated property for the annuity; removal of the property from one's estate by virtue of the lifetime transfer; avoiding or minimizing a gift tax to the extent that any gift element is covered by the annual exclusions, and/or the lifetime exemption; a charitable contribution deduction if the contract is with a charity to the extent that the value of the property exceeds the value of the charity's annuity promise; a high basis for depreciation in the obligor with a minimum equity investment from the early years of the annuity contract; and, finally, an absence of recapture of the tax benefits realized by the obligor, as a result of this "excessive" depreciation, upon a premature death of the annuitant as long as the obligor has held the property until the annuitant's death.

As long as these benefits continue to exist, the private annuity, especially when coupled, for example, with a variable feature such as providing for payments which may fluctuate based upon increases in the cost of living index, is a flexible tax planning technique through which important tax savings are made possible. Serious thought, therefore, should be given to the annuity in counseling individuals in their personal tax planning. Finally, in formulating deferred compensation plans, whether trusteeed or insured, it is advisable in today's inflationary economy to provide for variable annuity payments, or, at least, an annuity which permits a combination of a fixed and variable return.