

Intra-Family Sales Using Private Annuities: The House Wins

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INTRODUCTION

Today, there are a variety of well-established and acceptable estate planning and income tax planning techniques designed to reduce the amount subject to the Federal estate and gift taxes and save income taxes. The income tax planning techniques have as their objectives the deferral of income and the preservation of capital gains. Because there are no restrictions on the use of private annuities as there are with the installment method,¹ tax planners may be inclined to use an intra-family, private annuity sale to defer the reporting of the capital gain inherent in an appreciated asset before it is eventually sold for cash. The objective of this article is to illustrate that in almost all situations, when the income tax consequences to the purchasing family trust are taken into account, the financial detriments to the purchaser almost always outweigh the financial benefit to the seller of capital gain deferral.

The intra-family, private annuity sale is straight-forward. A senior family member ("Senior") owns an appreciated capital asset and intends to sell that asset for cash to a third party in the near future. Before the asset is sold for cash, Senior sells the appreciated capital asset to a non-grantor family trust (the "Purchaser") for the benefit of junior family members for an amount equal to its non-discounted fair market value, taking back the Purchaser's private annuity obligation as consideration for the purchase price. If the Purchaser is not a grantor trust, there is a realization event for Federal income tax purposes. As a separate tax person for Federal income tax purposes, the non-grantor trust has acquired the asset by purchase and takes as its cost basis in the asset the amount it paid for the asset. Under well-accepted income tax principles, a purchaser can include in its cost basis any non-contingent obligation incurred as part of the acquisition of the asset,² including the private annuity obligation created to pay the purchase price.³ If the Purchaser immediately sells the capital asset for an amount equal to what it paid for the capital asset, it will have no gain to report and can use the cash proceeds from that subsequent sale to finance its obligation to the seller.

The reason for the financial detriment is that the purchasing trust cannot take an ordinary deduction for the interest cost incurred when using private annuity financing as part of the purchase of an asset.⁴ Instead, since the purchasing trust acquired a capital asset, it must characterize its interest cost as a capital loss even though the seller must report the interest income as ordinary income. In effect, for every dollar of interest income reported as ordinary income by the seller, the Purchaser has a dollar of capital loss. Furthermore, the use of the capital loss deduction for the Purchaser's interest expense is postponed far beyond the first few years of annuity payments in which the seller reports the interest income. The combination of the characterization of the Purchaser's interest cost as a capital loss and the postponement of the purchaser's deduction for what is really an

interest expense create financial detriments to the purchasing trust that more than offset the financial benefits the seller achieves by deferring the reporting of the capital gain under the annuity rules found in §72.

A seller-financed, deferred payment sale, using the future cash flows from the Purchaser's sale proceeds from the newly-acquired asset as the primary source to satisfy the obligation undertaken by the Purchaser, can be structured as a private annuity.⁵ A private annuity provides for specified payments over a term of uncertain duration, typically the life of the selling senior family member or the joint lives of the senior family member and spouse. Although a private annuity, like any commercial annuity, involves an implicit interest factor, the interest is not expressly stated.

Under traditional income tax principles, the timing for reporting gain realized by the seller under the annuity rules is significantly different from that under the installment method. There are similar differences in the basis of the property acquired by the buyer. The buyer obligated under a private annuity sale must capitalize the interest cost even though it is interest/annuity income to the seller. The buyer in an installment sale can deduct as interest expense the amount the seller reports as interest income in the same year.

Even greater differences from the OID rules exist in the income taxation of the interest element inherent in each annuity payment. The seller reports the interest income as annuity income in a private annuity sale only upon actual receipt, and it is characterized as ordinary income. The buyer is not allowed any deduction for what is the practical equivalent of the interest cost in a private annuity obligation. An anomaly is that an unsecured private annuity obligation is governed by a different set of rules than a secured private annuity obligation on identical terms. Another distorting factor in the use of private annuities is the use of different interest rate and mortality assumptions for income tax purposes than those used for transfer tax purposes and for determining the annual annuity payments.

This article provides an empirical analysis of the income tax treatment of the private annuity financing arrangement (in so far as it is clear) to show how the selling senior family member and younger generation buyer are taxed at the time of the initial sale, the time each payment is made, and the death of the seller.

A private annuity can be used in either a sale to a grantor trust, which is not treated as a taxable sale for federal income tax purposes, or a sale to a non-grantor trust which is treated as a taxable sale for federal income tax purposes. Out of an excess of caution, if the sale is to a partnership, a limited liability company, a C corporation or S corporation, the transferor-seller should not be a substantial owner of the purchasing entity.⁶ And, to be absolutely safe on this aspect, the seller should not have any interest in the purchaser. Because the focus of this article is on the use of private annuities for income tax deferral, the author will not discuss private annuity sales to a purchasing entity that is a grantor trust.

INTRA-FAMILY PRIVATE ANNUITY SALES

Private annuity sales are arrangements that permit a senior family member to receive a fixed amount periodically for the remainder of the seller's life or the joint lives of the seller and the seller's spouse. The traditional tax treatment of private annuity sales developed in a series of rulings and cases as an application of cash accounting principles in combination with some of the rules that apply to primarily commercial annuities, all without specific statutory authority.

Commercial Annuities

Under a commercial annuity arrangement, the insurance company receives one or more premium payments and agrees to make a prescribed series of future payments, usually measured by the annuitant's life, a specified term or some combination. The payments represent not only return of the premium but also an implicit interest element for the annuity term. Under § 72, a portion of each annuity distribution is treated as a tax-free return of the annuitant's initial deposit by use of a mechanism called the "exclusion ratio," and the balance, representing what is essentially interest income, is annuity income.⁷ Any distributions representing the annuitant's cost in the annuity contract, referred to as the "investment in the contract,"⁸ are treated as a tax-free return of basis.⁹ This investment in the contract, the numerator of the exclusion ratio, is the total of premiums the annuitant paid the insurance company. The denominator of the exclusion ratio is the total of all amounts the annuitant expects to receive under the annuity contract (without discounting to present value) determined by actuarial tables,¹⁰ referred to as the "expected return."¹¹ The exclusion ratio in annuity taxation has a function similar to that of the gross profit ratio in the installment method as the mechanism for defining the recovery of basis. The exclusion ratio determines the amount of each payment that effectively represents interest income. This exclusion ratio differs in that it provides a straight-line allocation of the income on a cash basis rather than the compound-interest accrual approach of the OID rules.

When annuity payments are payable for a period measured by a life, the annuitant can die before or after the actuarial life expectancy age provided in the mortality table. An annuitant who dies exactly when his actuarial life expectancy ends excludes from income an amount exactly equal to the premiums paid. An annuitant who dies prematurely deducts the unrecovered "investment in the contract" on the final income tax return.¹² An annuitant who survives beyond the life expectancy according to the mortality table recovers the entire investment in the contract, and can no longer exclude any portion of subsequent annuity payments.¹³

Private Annuities in General

When a senior family member sells the family business or other financial assets to a junior family member on terms that measure the payments by the selling senior family member's (or another person's) life, the transaction is a private annuity sale. Traditional private annuity sale treatment is a special application of cash accounting principles, in which the gain on the sale is allocated over the payment period using the principles of annuity taxation outlined above.¹⁴ A deferred payment redemption by a family corporation can be a private annuity obligation.¹⁵

During the actuarial life expectancy of the selling senior family member in a private annuity sale, the annuity payments are divided into three parts: (1) a basis recovery element, determined by allocating the basis of the shares over the selling shareholder's life expectancy under the income tax annuity tables; (2) a (capital) gain element, measured by any excess of the value of the annuity under the gift tax actuarial tables over the basis of the shares, which is also allocated over the income tax life expectancy; and (3) an annuity (or interest) income element, measured by the difference between the amount of the payment and the sum of the first two items, using the lower of the fair market value of the family business or the present value of the annuity to measure the payment.¹⁶ Thus the recovery exclusion in a private annuity sale is divided between the recovery of the selling senior family member's basis in the assets transferred and any unrealized gain inherent in those assets. Accordingly, private annuity sale treatment parallels the installment method, but with significant differences.

Surprisingly, traditional private annuity sale treatment is not available for secured private

annuity sales.¹⁷ Although GCM 39503 seems to assume that being ineligible for private annuity sale treatment means immediate recognition of gain,¹⁸ this is questionable. The cases requiring immediate recognition for secured private annuity sales did so as an application of cash accounting principles and did not discuss installment sales, because, at that time, contingent deferred payment sales were not eligible for installment sale treatment. This is no longer true. Accordingly, the IRS position may create an anomaly in that an unsecured private annuity sale is taxed under annuity principles, while an identical secured one is an installment sale. Despite this possibility, most commentators assume that if a private annuity is secured, immediate gain recognition is required.

The buying family member is not entitled to any interest deduction even though the portion of the payment representing the time value of money is annuity income for the selling family member.¹⁹ On the other hand, the buyer's initial basis of the family assets transferred is measured by the anticipated payments to the extent of the fair market value of the annuity obligation.²⁰ Both of these results are inconsistent with those that apply to contingent payment installment sales, but are consistent with the exclusion of annuity transactions from the OID rules.²¹ Even with that exclusion, the denial of an interest deduction for the younger generation buyer is questionable. However, the courts have supported the IRS's denial of an interest deduction.²²

The younger generation buyer's initial tentative basis in the property is increased when the aggregate of the actual payments exceed the initial tentative basis.²³ Because there is no interest deduction, this occurs well before the end of the selling senior family member's actuarial life expectancy and can lead to a final basis far in excess of value. If the family seller dies before payments equal the tentative basis, the basis is reduced to payments already made.²⁴ A buyer who disposes of the property during the selling family member's lifetime generally computes gain or loss using the tentative basis at the time of the sale. Subsequent payments are additional losses on sale of the family assets.²⁵

When an intended source of payment for the deferred payment obligation to purchase the family business (or other family financial assets) is the income generated by the assets purchased, and the payment is dependent on the selling senior family member's life, there is an appearance of a trust equivalent where there is a retained interest in the property transferred. Nevertheless, the family assets sold should not be included in the gross estate of the selling senior family member as a retained life estate under §2036(a). Section 2701 applies only to retained equity interests, and, thus, does not apply to debt obligations. Accordingly, a bona fide deferred payment sale should fall outside of §2701 even when the payment is in the form of a private annuity sale, but not if the payments are dependent on earnings.²⁶

Income Tax Treatment of Annuities

An individual who saves by depositing money in a commercial savings account must report the interest earned each year under the doctrine of constructive receipt even if no withdrawals are made. Even an individual who buys a long-term certificate of deposit where early withdrawal incurs a penalty must report interest as earned under the OID rules.²⁷

Example 1: A deposits \$2,486.90 in a savings account on January 1, 2000. The bank pays 10.0% annual interest. A intends to withdraw \$ 1,000 annually for the next three years beginning on December 31, 2000. The following illustrates the

interest income earned each year:

Deposit on January 1, 2000	\$2,486.90
Interest at 10.0% for 2000	+ 248.69
Withdrawal on December 31, 2000	- 1,000.00
Balance on January 1, 2001	\$1,735.59
Interest at 10.0% for 2001	+ 173.55
Withdrawal on December 31, 2001	- 1,000.00
Balance on January 1, 2002	\$ 909.14
Interest at 10.0% for 2002	+ 90.91
Withdrawal on December 31, 2002	- 1,000.00
Balance	-0-

When an individual purchases an annuity, the implicit interest in the internal buildup in the policy is not taxed currently. The doctrine of constructive receipt does not apply because the annuitant does not have a right to withdraw as the interest is earned. Instead, the basic mechanism is to bifurcate each annuity payment between basis recovery and income on a straight line basis by use of the "exclusion ratio,"²⁸ the fraction determined by dividing the annuitant's "investment in the contract"²⁹ by the "expected return,"³⁰ that is, the total of the undiscounted payments to be made. If all payments to be made are not subject to any contingencies, then the guaranteed number of payments is used to determine the expected return.³¹ If there is a contingency, such as payments to be made for the rest of the annuitant's life, then the life expectancy of the annuitant at the "annuity starting date" is the multiple used to determine the expected return.³² The annuity starting date is the date in the future that the annuity payments are to commence.³³ The life expectancy multiples used in determining the expected return are prescribed in the regulations under §72.³⁴

Example 2: B purchases an annuity on January 1, 2000 for \$2,486.90, which equals the present value of \$1,000 a year for three years at 10.0%, the \$7520 rate. This annuity contract provides that B will receive \$1,000 annually for three years, the first payment to be made on December 31, 2000. The "investment in the contract" is \$2,486.90 (the premium paid). The "expected return" is \$3,000. The "exclusion ratio" is 82.89%. Therefore, B must report \$171.03 of income every time he receives a \$1,000 annuity payment.

The annuity reporting rules do not change the aggregate amount of income reported. But the timing rules for annuities create a deferral advantage.

<i>Year</i>	<i>Table A Annuity Income</i>	<i>Interest Income</i>
2000	\$171	\$249
2001	171	174
2002	171	90
Total	\$513	\$513

Private Annuity Sales to a Non-Grantor Trust

The traditional income tax treatment of private annuity sales developed before the Installment Sales Revision Act of 1980 extended installment sale treatment to contingent payment sales,³⁵ presumably including sales with payments in the form of an annuity.

The following facts will be used to illustrate the tax consequences of the private annuity examples below.

Example 3: S is 70 years old. On December 2, 2004, S sells the stock in a family business to B for \$ 10,000,000. S's basis for the stock is \$2,000,000.

Under Regs. §1.72-9, Table V, a 70 year old has a life expectancy of 16.0 years. However, the estate and gift tax valuation tables in Regs. §20.2031-7(f), which adopt the tables in Book Aleph (the 90CM tables), use 13.9 years as the life expectancy of a 70 year old for purposes of computing the periodic annuity payments.

As announced in Rev. Rul. 2004-106³⁶ the interest rates for December 2004 are: (i) annual long-term AFR 4.68% and, (ii) § 7520 rate 4.2%.

Installment Sale

For comparison purposes, the first illustration is a self-amortizing installment sale in which the younger generation buyer makes level annual payments over a fixed term. When all payments are fixed, the deferred payment arrangement is an installment sale governed by the installment reporting rules under §453. The 16-year term for the payments corresponds to the selling senior family member's 16-year life expectancy used in the income tax tables.³⁷

Example 4: On December 2, 2004, S sells shares in his family business, with a basis of \$2,000,000, to B, a related party, for \$10,000,000. S agrees to finance the entire purchase price over 16 years. B will pay interest at 4.68%, the long-term AFR for December 2004. A gross profit ratio of 80% is applied to each principal payment to determine the amount of capital gain reported under the installment method.

Using 4.68% annual interest, the self-amortizing annual payment is \$901,802. For income tax purposes, B's basis is \$10,000,000. The amount, character and timing of S's income upon receipt of each annual payment, using an 80% gross profit ratio for each principal payment, is:

<i>Year</i>	<i>Annual Payment</i>	<i>Interest (4.68%)</i>	<i>Capital Gain</i>	<i>Basis</i>	<i>Principal Balance</i>
12-2-04	--	--	--	--	\$10,000,000

12-1-05	\$ 901,802	\$ 468,000	\$ 347,042	\$ 86,760	9,566,198
12-1-06	901,802	447,698	363,284	90,821	9,112,093
12-1-07	901,802	426,446	380,285	95,071	8,636,737
12-1-08	901,802	404,199	398,083	99,521	8,139,134
12-1-09	901,802	380,911	416,713	104,178	7,618,243
12-1-10	901,802	356,534	436,215	109,054	7,072,974
12-1-11	901,802	331,015	456,630	114,157	6,502,187
12-1-12	901,802	304,302	478,000	119,500	5,904,687
12-1-13	901,802	276,339	500,370	125,093	5,279,224
12-1-14	901,802	247,068	523,788	130,947	4,624,489
12-1-15	901,802	216,426	548,301	137,075	3,939,112
12-1-16	901,802	184,350	573,962	143,490	3,221,660
12-1-17	901,802	150,774	600,823	150,206	2,470,632
12-1-18	901,802	115,226	628,941	157,235	1,684,455
12-1-19	901,802	78,832	658,376	164,594	861,485
12-1-20	901,802	40,317	689,188	172,297	(0)
	\$14,428,839	\$4,428,839	\$8,000,000	\$2,000,000	

As the above indicates, the 80% gross profit ratio is applied each year to an increasing principal payment. As the outstanding principal balance is reduced each year, the interest portion of each succeeding payment decreases. If any of the seller-provided financing is later canceled, the amount of the cancellation is a purchase price adjustment that reduces the buyer's basis.³⁸

Traditional Treatment of Unsecured Private Annuities

Because the IRS does not treat a private annuity as a contingent payment installment sale, the IRS requires the reporting of private annuity sales under the annuity rules.³⁹ Under the annuity rules, the buyer's basis initially equals the value of the private annuity obligation, but changes depending upon the aggregate amount the buyer pays under the annuity arrangement.⁴⁰

This "tentative basis" is finally determined only after the seller dies, and all payments are finally fixed. The buyer's "final" basis is equal to the aggregate of all annuity payments made to the seller.

Once the total of all payments made exceeds the tentative basis amount, each additional payment is added to the buyer's basis. The basis only becomes final when the payments cease. If the seller dies before the total of the annuity payments made equals the tentative basis amount, then the final basis is an amount equal to the payments actually made. If the buyer sells the family business or other financial assets before the seller's death, there is a split basis, with gain determined using the tentative basis, but loss allowed only to the extent the sale price is less than payments made.⁴¹ All subsequent payments are loss, whether gain or loss was realized on the interim sale of the family business or other financial assets.

No interest is imputed for any annuity payment made by the buyer.⁴² The effect is that the entire amount of each annuity payment made by the buyer is treated as a principal payment. The inability of the buyer to treat any portion of an annuity payment as interest expense requires the buyer to capitalize, as part of his basis, what is realistically an interest expense. Because the buyer cannot treat any portion of the annuity payment as interest expense, the total of the actual payments will exceed the tentative basis amount well before the seller reaches his actuarial life expectancy. Therefore, a buyer using a

private annuity sale arrangement can expect to have a basis for an asset far greater than the amount he paid for it (i.e., greater than its value), unless the seller dies prematurely.

Another distortion is caused when the generally higher interest rates (the §7520 rate is 120% of the mid-term AFR) and shorter mortality assumptions found in the gift tax valuation tables under Regs. §20.2031-7(f), which adopts Book Aleph, are used to calculate the annuity payments. The amount of each annuity payment will be larger than if the lower income tax interest rate and longer income tax mortality assumptions were used. Since Rev. Rul. 55-119 requires the use of the gift tax valuation tables,⁴³ the younger generation buyer can end up undertaking an obligation that has a value greater than the value of the property purchased as determined under the OID rules. If the buyer lives to the longer actuarial life expectancy used in Regs. §1.72-9, Table V, the buyer will end up paying far more for the property than it may be worth, with a resultant basis greater than its value.

Example 5: The facts are the same as in Example 3. B, the buyer, agrees to pay S an annual annuity payment for the rest of the S's life. If the annual annuity payment is computed using the transfer tax tables in Book Aleph⁴⁴ at 4.2%, the § 7520 rate, the annual annuity is \$1,030,471.

The investment in the contract is \$2,000,000. The expected return is \$16,487,536 (\$1,030,471 × 16.0 year life expectancy using the income tax annuity tables). Therefore, the exclusion ratio is 12.52%.⁴⁵

Assume that S survives for 19 years and dies on 12/15/23, receiving 19 annual annuity payments. Under the §72 annuity rules the amount, character and timing of S's income is as follows:

Date	Annual Payment	Annuity Income	Capital Gain	Basis (12.52%)
12-1-05	\$ 1,030,471	\$ 385,310	\$ 516,129	\$ 129,032
12-1-06	1,030,471	385,310	516,129	129,032
12-1-07	1,030,471	385,310	516,129	129,032
12-1-08	1,030,471	385,310	516,129	129,032
12-1-09	1,030,471	385,310	516,129	129,032
12-1-10	1,030,471	385,310	516,129	129,032
12-1-11	1,030,471	385,310	516,129	129,032
12-1-12	1,030,471	385,310	516,129	129,032
12-1-13	1,030,471	385,310	516,129	129,032
12-1-14	1,030,471	385,310	516,129	129,032
12-1-15	1,030,471	385,310	516,129	129,032
12-1-16	1,030,471	385,310	516,129	129,032
12-1-17	1,030,471	385,310	516,129	129,032
12-1-18	1,030,471	385,310	516,129	129,032
12-1-19	1,030,471	385,310	516,129	129,032
12-1-20 ⁴⁶	1,030,471	707,890	258,065	64,516
12-1-21	1,030,471	1,030,471	-0-	-0-
12-1-22	1,030,471	1,030,471	-0-	-0-
12-1-23	1,030,471	1,030,471	-0-	-0-

Total \$19,578,950 \$9,578,950 \$8,000,000 \$2,000,000

As illustrated below, the younger generation buyer's basis in a private annuity sale reported under the annuity rules exceeds the value of the property purchased far before the selling senior family member reaches the end of his actuarial life expectancy. This is because the buyer cannot deduct any portion of his annuity payments as interest expense, and because the transfer tax tables used in determining the annual annuity payments use shorter life expectancies and higher interest rates, thereby increasing the amount of the annual annuity payment that is required to avoid gift tax.

Example 6: B's tentative basis for the private annuity sale in Example 5 is \$1,000,000, the present value of the annuity obligation using the transfer tax tables at 4.2%, the §7520 rate. As the annuity payments are made, B's tentative and final basis is as follows:

Date	Annual Payment	Payments to Date	Tentative Basis ⁴⁷
12-1-05	\$1,030,471	\$1,030,471	\$10,000,000
12-1-06	1,030,471	2,060,942	10,000,000
12-1-07	1,030,471	3,091,413	10,000,000
12-1-08	1,030,471	4,121,884	10,000,000
12-1-09	1,030,471	5,152,355	10,000,000
12-1-10	1,030,471	6,182,826	10,000,000
12-1-11	1,030,471	7,213,297	10,000,000
12-1-12	1,030,471	8,243,768	10,000,000
12-1-13 ⁴⁸	1,030,471	9,274,239	10,000,000
12-1-14	1,030,471	10,304,710	10,304,710
12-1-15	1,030,471	11,335,181	11,335,181
12-1-16	1,030,471	12,365,652	12,365,652
12-1-17	1,030,471	13,396,123	13,396,123
12-1-18	1,030,471	14,426,594	14,426,584
12-1-19	1,030,471	15,457,065	15,457,065
12-1-20	1,030,471	16,487,536	16,487,536
12-1-21	1,030,471	17,518,007	17,518,007
12-1-22	1,030,471	18,548,478	18,548,478
12-1-23	1,030,471	19,578,949	19,578,949

If the selling senior family member in a private annuity sale reported under the §72 annuity rules dies before reaching his actuarial life expectancy, there is an unrecovered "investment in the contract." Presumably, the seller may deduct any unrecovered basis on his final income tax return under §72(b)(3)(A). The character of the loss for unrecovered basis should be determined by reference to the character of the property sold, rather than being viewed as a loss in an independent annuity transaction.⁴⁹ Where the asset sold is a capital asset, the loss is a capital loss. Nevertheless, when the buyer in a private annuity sale is related to the seller, the loss provided an annuitant for unrecovered basis on premature death should not be disallowed under the related party rule of § 267(a)(1) because it is not part of the sale, but part of the annuity transaction.⁵⁰

Example 7: If S dies at the end of the year 2014 at age 80, having received only 10 of the expected 16 annual payments, the remaining, unrecovered basis is \$709,680. S is permitted to deduct \$709,680 on his final income tax return as a long-term capital loss. B's basis is finally determined to be \$10,304,710, the aggregate of all payments made for 10 years.

The private annuity sale to a non-grantor trust appears attractive because the purchaser takes a "tentative" basis in the capital asset equal to the annuity obligation.⁵¹ The purchaser can then depreciate the entire "tentative" basis and use the "tentative" basis for determining gain or loss upon a subsequent sale of the capital asset.

Example 8: Using the facts from Example 5, B, the Buyer, has a \$10,000,000 basis in the purchased shares. One month later, B sells the shares for \$10,150,000. B realizes only a \$150,000 short-term capital gain and is now free to use all \$10,150,000 of the cash sale proceeds for any purpose. Even though B resold the same asset purchased from S within two years⁵² and even though S and B are related parties, S can continue to defer the reporting of S's \$8,000,000 long-term capital gain under the §72 annuity rules.

If the purchaser disposes of the asset prior to the death of the individual used as the measuring life, Rev. Rul. 55-119 goes on to provide that the purchaser realizes a future loss when the aggregate of all annuity payments made by the purchaser exceed the purchaser's "tentative" basis. In other words, when all annuity payments made by the purchaser both before and after the purchaser's disposition exceed the purchaser's original "tentative" basis, such excess is a loss in the year or years paid. The ruling goes on to state that the purchaser may deduct any annuity payment in excess of the "tentative" basis in the year in which paid. Furthermore, the ruling states that the nature of such loss is characterized by how the asset was held by the purchaser at the time of the purchaser's previous disposition.⁵³

Example 9: Using the table illustrating the purchaser's tentative basis in Example 6, B reports a short-term capital loss of \$304,710 on B's income tax return for 2014. And, for each subsequent year until the annuitant dies, B continues to report a \$1,031,471 short-term capital loss.

The dichotomy is that the purchaser's interest cost is deducted as a capital loss while the seller's interest income is reported as ordinary income. And, timing symmetry between the original seller and buyer does not exist. The buyer's deduction for the interest cost is postponed until the aggregate of all annuity payments exceeds the buyer's tentative basis while the seller reports the interest element (the "annuity" income) as each annuity payment is received. As illustrated in Example 6 above, the buyer cannot take a deduction until 10 years after the annuity sale. The combination of these factors generally causes a financial detriment to the purchaser that can far exceed the financial benefit to the seller's deferral of reporting the capital gain.⁵⁴

Empirical Analysis of Private Annuity Sales

As discussed above, the IRS's position regarding a non-grantor trust's basis in an asset acquired in exchange for a private annuity was set forth in Rev. Rul. 55-119⁵⁵ and has remained unchanged despite the substantial revisions to the installment sale rules in 1980, the enactment of the OID rules in 1984 and the adoption of the contingent payment sale regulations in 1996.⁵⁶ If the purchaser sells the asset purchased with the private annuity while the annuitant is still alive, the purchaser is permitted to use the "tentative" basis (i.e., the amount of the private annuity obligation) in determining the realized gain or loss on that disposition. Once the aggregate of the purchaser's actual annuity payments exceed the initial "tentative" basis, Rev. Rul. 55-119 goes on to allow the purchaser to deduct the excess in the year or years paid. In effect, Rev. Rul. 55-119 permits the private annuity purchaser to adjust in later years the gain or loss reported at the time of the prior disposition as excess annuity payments are made.

The private annuity sale illustrated in Examples 5 and 6 above will be used to discuss the factors which create a financial detriment to the purchaser. In order to illustrate these factors, state income taxes must be taken into account. Therefore, it is assumed that both S and B are residents of New York State. Because the intra-family private annuity sale is primarily an income tax deferral technique, an assumed investment rate of return needs to be used. After all, the ability to postpone the payment of the income taxes on a gain is the equivalent of an interest-free loan of the income taxes deferred. For this purpose, an 8.6% investment rate of return is used in Examples 10, 11 and 12, consisting of 5.16% long-term capital gain and 3.44% ordinary income. The examples project the results for 16 years, which is the life expectancy of a 70-year-old person under Regs. §1.72-9 Table V.

Example 10 assumes that S did not engage in the intra-family private annuity sale, paid the \$1,590,000 in combined Federal and New York State income taxes on the \$8,000,000 long-term capital gain and immediately invested the \$8,410,000 of after-tax sale proceeds at the assumed 8.6% rate of return. In Examples 10, 11 and 12 it is further assumed that all earnings from the investment of the sale proceeds are reinvested at the same 8.6% rate of return.

Example 10 illustrates that at the end of 16 years, the original \$8,410,000 will have grown to \$21,655,786. In order for the income tax deferral of the capital gain to be financially advantageous, the total of the amounts accumulated by the seller and the purchaser in a private annuity sale at the end of 16 years must exceed the total the seller accumulated if no private annuity sale took place. Example 11 illustrates the seller's \$19,648,913 accumulation after receiving annuity payments for 16 years and investing all amounts at an 8.6% investment rate of return. Example 12 illustrates the purchaser's negative \$418,251 accumulation, assuming the purchaser immediately sold the capital asset in 2004 for the same amount the purchaser paid for it, made annuity payments for the next 16 years and invested all amounts at an 8.6% investment rate of return. At the end of 16 years, the aggregate accumulation by the seller and the purchaser is only \$19,230,662, which is \$2,425,124 less than if the seller had not engaged in the private annuity sale.

Examples 11 and 12 highlight the three factors that contribute to the purchaser and the seller being \$2,425,124 worse off. Over the 16-year period the total for all annuity payments is \$16,487,536, consisting of \$10,000,000 of principal and \$6,487,536 of interest. Both the seller and the purchaser end up reporting the same \$6,487,536 of interest, as income and deduction respectively, but there are significant timing differences as the following Table illustrates:

Table 1

Year	Seller's interest	Purchaser's interest
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	income	deduction
2005	\$385,310	-
2006	385,310	-
2007	385,310	-
2008	385,310	-
2009	385,310	-
2010	385,310	-
2011	385,310	-
2012	385,310	-
2013	385,310	-
2014	385,310	304,710
2015	385,310	1,030,471
2016	385,310	1,030,471
2017	385,310	1,030,471
2018	385,310	1,030,471
2019	385,310	1,030,471
2020	707,886	1,030,471
Totals	\$6,487,536	\$6,487,536

As the above Table 1 illustrates, during the first nine years of annuity payments, the seller reports \$3,467,790 of interest income before the purchaser can begin to deduct the interest costs.

The second disadvantage occurs because all of the interest income received by the seller is reported as ordinary income, taxable at a combined Federal and state income tax rate of 39.875%. At the same time, the purchaser must report its interest cost as a capital loss, which can only reduce capital gains and up to \$3,000 of ordinary income a year. Since the combined Federal and state tax income tax rate for long-term capital gains is 19.875% (24.875% beginning in 2009) there is a 20% or 15% rate differential between ordinary income and long-term capital gains. Thus, the seller pays \$2,381,455 of income taxes on his interest income while the purchaser is only able to reduce its income taxes by \$1,613,775. Because of this 15% rate differential beginning in 2009, the seller and the purchaser are \$767,680 worse off.⁵⁷

Besides the timing disparity between reporting the seller's interest income and the purchaser's interest deduction and the 20%/15% rate differential, there is a third factor that further increases the financial detriment. Because a capital loss can only offset capital gains and up to \$3,000 of ordinary income each year, the purchaser's capital loss cannot be deducted fully if the purchaser does not have sufficient capital gains for the year. Examine the 2015 tax year in Example 12, the first year the purchaser can report its entire \$1,030,471 annuity payment as a capital loss. For that year the purchaser only reports a \$237,181 capital gain. Therefore, the purchaser is unable to deduct \$790,290 of the capital loss reported for that year. Under the column labelled "Tax Benefits From Annuity Payments in Excess of Basis" for 2015, the purchaser is able to use only \$237,181 of the capital loss to offset capital gains and \$3,000 of the capital loss to offset ordinary income. Only the \$58,999 income taxes the purchaser would have paid on its \$237,181 of capital gain and the \$1,196 of taxes on \$3,000 of ordinary income is eliminated by the \$1,030,471 capital loss. Thus, the tax savings from the \$1,030,471 capital loss deduction for 2015 is limited to \$60,195.

One way to reduce the financial detriment caused by the inability to use the entire capital loss is for the purchaser to create more capital gains from its investments. However,

even this investment strategy may not be able to fully utilize the entire \$1,030,471 capital loss. If the purchaser's entire 8.6% rated return on its investments was a long-term capital gain, it would still not generate a sufficient amount of capital gains to utilize the entire capital loss deduction.⁵⁸

One may try to restructure the private annuity sale to further enhance the income tax deferral by using a younger measuring life for the annuitant. Logic would dictate that with a longer deferral period, which would create an additional financial benefit for the seller, the private annuity sale should be able to produce a financial benefit for the seller that would exceed the financial detriment to the purchaser. However, this is not the case. By lengthening the annuity payout period, more interest is created. The increased benefit to the seller is offset because a longer deferral increases the total interest cost paid by the purchaser.⁵⁹ Likewise, deferring the annuity starting date can reduce, but cannot eliminate the entire financial detriment to the purchaser.

Example 10 - Senior with No Tax Plan

Year	Realized Income Before Taxes		Income Tax on Realized Income		Net Cash After Income Taxes	Ending Principal
	Ordinary Income	Capital Gain	Ordinary Income	Capital Gain		
	3.44%	5.16%			<i>Selling Price</i>	\$10,000
					<i>Less: Tax on Sale</i>	1,590,0
					<i>Net Proceeds</i>	\$8,410,0
2005	289,304	433,956	115,360	86,249	521,651	8,931,6
2006	307,249	460,873	122,515	91,599	554,008	9,485,6
2007	326,307	489,460	130,115	97,280	588,372	10,074,
2008	346,547	519,820	138,185	103,314	624,867	10,698,
2009	368,042	552,063	146,757	109,723	663,626	11,362,
2010	390,871	586,306	155,860	116,528	704,789	12,067,
2011	415,116	622,673	165,527	123,756	748,505	12,815,
2012	440,864	661,296	175,795	131,433	794,933	13,610,
2013	468,210	702,315	186,699	139,585	844,241	14,454,
2014	497,252	745,878	198,279	185,537	859,313	15,314,
2015	526,812	790,218	210,066	196,567	910,397	16,224,
2016	558,130	837,195	222,554	208,252	964,518	17,189,
2017	591,309	886,964	235,785	220,632	1,021,856	18,211,
2018	626,461	939,692	249,801	233,748	1,082,603	19,293,
2019	663,703	995,554	264,651	247,644	1,146,961	20,440,
2020	703,158	1,054,737	280,384	262,366	1,215,145	21,655,

Example 11 - Senior With Tax Plan

	Taxability of Annuity	Realized Income Before Income
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Year	Annual Annuity Payment Received	Ordinary Income Portion	Long Term Capital Gain	Tax Free Portion (Principal)	Ordinary Income	Capital Gain
					3.44%	5
2005	1,030,471	385,310	516,129	129,032		
2006	1,030,471	385,310	516,129	129,032	26,634	39
2007	1,030,471	385,310	516,129	129,032	54,920	82
2008	1,030,471	385,310	516,129	129,032	84,961	125
2009	1,030,471	385,310	516,129	129,032	116,865	174
2010	1,030,471	385,310	516,129	129,032	150,748	223
2011	1,030,471	385,310	516,129	129,032	186,733	272
2012	1,030,471	385,310	516,129	129,032	224,949	321
2013	1,030,471	385,310	516,129	129,032	265,537	370
2014	1,030,471	385,310	516,129	129,032	308,641	419
2015	1,030,471	385,310	516,129	129,032	352,736	468
2016	1,030,471	385,310	516,129	129,032	399,451	517
2017	1,030,471	385,310	516,129	129,032	448,944	566
2018	1,030,471	385,310	516,129	129,032	501,379	615
2019	1,030,471	385,310	516,129	129,032	556,931	664
2020	1,030,471	707,886	258,065	64,520	615,786	713
Totals	\$16,487,536		\$8,000,000	\$2,000,000		

Example 12 - Trust With Tax Plan

Year	Annual Annuity Payment Made	Realized Income Before Income Taxes		Income Tax on Realized Income		Tax Benefit From Annuity Payment Excess Basis
		Ordinary Income	Capital Gain	Ordinary Income	Capital Gain	
		3.44%	5.16%			
2005	1,030,471	344,000	516,000	137,170	102,555	
2006	1,030,471	329,889	494,834	131,543	98,348	
2007	1,030,471	314,903	472,355	125,568	93,881	
2008	1,030,471	298,988	448,482	119,221	89,136	
2009	1,030,471	282,085	423,127	112,481	84,097	
2010	1,030,471	264,134	396,201	105,323	78,745	
2011	1,030,471	245,069	367,604	97,721	73,061	
2012	1,030,471	224,822	337,233	89,648	67,025	
2013	1,030,471	203,319	304,978	81,073	60,614	
2014	1,030,471	180,482	270,723	71,967	67,342	68,539
2015	1,030,471	158,121	237,181	63,051	58,999	60,195
2016	1,030,471	134,143	201,215	53,790	50,052	51,248
2017	1,030,471	108,432	162,649	43,237	40,459	41,655
2018	1,030,471	80,863	121,295	32,244	30,172	31,368

2019	1,030,471	51,301	76,952	20,456	19,142	20,338
2020	1,030,471	19,602	29,403	7,816	7,314	8,510
	\$16,487,536					

Secured Private Annuity

There is some confusion about what rules apply if the annuity obligation is secured by the property transferred. The obligation is apparently excluded from being a debt obligation for OID purposes, even under Regs. §1.1275-1(j), because there are no provisions that can significantly reduce the probability that the total payments under the contract will increase commensurately with Senior's longevity. On the other hand, there is significant authority that a secured private annuity is not entitled to deferral under the private annuity rules, apparently because only unfunded, unsecured obligations are not treated as payment under the cash method.⁶⁰ Although the conclusion in those authorities was that the gain was recognized immediately at the time of sale, they were decided for tax years before the enactment of §453(j)(2) that expressly recognizes contingent payment installment sales.⁶¹ Accordingly, if it is not a private annuity under §72, a disposition of qualifying property for a secured private annuity based solely on Senior's life should be treated as a contingent payment installment sale. The obligation, however, apparently is not a debt obligation under Regs. §1.1275-1(j) because security is not one of the factors listed for qualifying for the annuity exclusion. As a contingent payment installment sale, the OID rules would treat a portion of each annuity payment as an interest expense.⁶² Since it appears that the IRS will not treat a secured private annuity as an installment sale, the IRS will then require all gain to be recognized at the time of the initial sale. Since the author believes that it is unsound to have radically different tax treatment of secured and unsecured private annuities, the author favors treating all private annuities as contingent payment installment sales. Since this recommendation has not yet been adopted by any regulations, ruling or other published IRS authority, despite Congressional authority to do so,⁶³ or by any court decision, traditional private annuity treatment apparently remains available only for unsecured private annuities.

As illustrated above, the capital gain realized on the private annuity sale is reported ratably over the life expectancy of the annuitant, but the life expectancy for this purpose is that in Regs. §1.72-9 Table V instead of the shorter one in used to determine the annual annuity under Table 90CM. Under Table 90CM an individual age 70 has a life expectancy of 13.9 years. Under the §72 table, an individual age 70 has a life expectancy of 16.0 years.⁶⁴ Obviously, the younger the individual, the longer the life expectancy and longer deferral can be achieved. A joint and survivor annuity for the senior family member and that individual's spouse increases the deferral. For example, the joint life expectancy of two individuals, both age 70, is 20.6 years for §72 purposes, as opposed to the 16.0 years for one individual age 70.

Comparison of Installment Method to Annuity Rules

The differences between the income tax treatment of installment sales and private annuity sales makes the choice between them ridiculously complex.

The following list details the large number of differences that makes this choice a true challenge to the tax professional.

- (i) The buyer's basis is determined at the initial time of purchase using the value of the buyer's obligation for a fixed payment installment sale, tentatively determined at the actuarial value of the annuity in a private annuity sale, and may be determined

only as payments become fixed for contingent installment sales.⁶⁵

(ii) The buyer is permitted an interest deduction in fixed or contingent payment installment sales, but not in private annuity sales.

(iii) The seller reports interest income as it financially accrues, back- or front-loaded for installment sales, but a uniform annual amount for private annuity sales.

(iv) If the buyer's obligation for a fixed or contingent installment obligation is terminated prior to maturity, the seller or the estate must report the remaining capital gain, if the buyer and seller are related parties, under the installment method,⁶⁶ but not for a private annuity sale. Consequently, the seller does not have unrecovered basis in an installment sale, but may in a private annuity sale.

(v) Depreciation recapture cannot be deferred under the installment method,⁶⁷ but there is no similar limitation for private annuity sales.

(vi) The anti-*Rushing* rule of §453(e) for a subsequent sale by a related purchaser applies to installment sales, but not to private annuity sales.

(vii) The installment method is not available for sales of depreciable property to related parties,⁶⁸ but there is no similar limitation for private annuity sales.

(viii) The installment method is not available for dealer or inventory sales, but may be for private annuity sales.

(ix) The seller in a large installment sale may be required to pay interest under §453A on taxes deferred under the installment method, but there is no similar requirement for private annuity sales.⁶⁹

(x) Pledging of an installment obligation as collateral for a loan results in reporting of the gain otherwise deferred,⁷⁰ with no similar provision for private annuity sales.

(xi) The installment method is not available if the buyer's obligation is readily tradable,⁷¹ but such trading may not prevent qualification as a private annuity sale.

(xii) The installment method is available even if the buyer's obligation is secured, but the private annuity sale approach is not.

(xiii) The installment method is not available for deferred payment sales of publicly-traded securities,⁷² but the private annuity sale approach may be.

(xiv) The OID and imputed interest rules apparently determine the transfer tax value of obligations taxed under the installment

method, but do not apply to private annuity sales,⁷³ so that the value is determined by discounting under the §7520 rate.

(xv) The status of a seller's health and other factors may be considered in an installment sale, but the actuarial tables will control private annuity sales unless the seller is unlikely to live more than one year.

(xvi) Specific rules control when the selling senior family member elects out of the installment method that generally prohibit use of the basis-first method; similar, but different rules avoid basis-first recovery for private annuity sales.

(xvii) The installment method can be used by shareholders for obligations resulting from a corporate sale of property,⁷⁴ but there is no similar express provision for private annuity sales.

(xviii) An S corporation can distribute an installment obligation without immediate gain recognition,⁷⁵ but there is no similar provision for private annuity sales.

Unresolved Tax Issues: Valuation Departures from the Actuarial Tables

In Rev. Rul. 77-454,⁷⁶ the IRS imposed a minimum funding standard on a trust that paid for the asset purchased by issuing its private annuity obligation. The purchasing trust was obligated to only one annuitant. The IRS was concerned about the trusts' ability to pay the annuity if the annuitant lived beyond his actuarial life expectancy. Accordingly, the ruling determined how many annual payments could be made by the trust taking into account its initial corpus plus earnings at the assumed interest rate. Using Table S (4.2%) in Book Aleph for an individual age 70, the annuity factor is 9.7043. Therefore, an annuity payable annually, at the §7520 rate of 4.2% for \$1,000,000 is \$103,047 ($\$1,000,000 \div 9.7043 = \$103,047$).⁷⁷ A 70-year old individual has a 90CM life expectancy of 13.9 years. If he lives to age 83.9, he will have consumed the entire original corpus plus income at 4.2% by age 83.9. Accordingly, Rev. Rul. 77-454 determines the gift by recasting the annuity as one for the lesser of 13.9 years or life, which has a value of \$809,673.55, resulting in a taxable gift of \$190,326.45. In order to have a value of \$1,000,000, the initial corpus must be sufficient to fund the annuity to age 110, the maximum age on table 90CM. The amount needed is \$1,960,405. Accordingly, to avoid any gift tax, the family trust must have additional funding of \$960,405. Presumably, as with family trusts used for installment sales, the additional funding can be provided by arrangements other than current or prior transfers, including guarantees.⁷⁸ If the purchaser is an individual, there is no extra funding requirement as it is presumed an individual has the ability to obtain additional funds by his or her ability to earn future income. One way to lower the capital reserves is to use an annuity for joint lives. For example, using a 4.2% §7520 rate, an annuity for the joint lives of a married couple, both age 70, is \$81,854 and the amount of the required capital reserve is \$560,000.⁷⁹

If one accepts the IRS's view in Rev. Rul. 77-454 as correct, then this approach should be used in determining the minimum funding of the purchasing trust. There are practitioners who apply the mythical 10% minimum funding standard used for installment sales to grantor trusts for private annuity sales. Obviously, if one wants a minimum funding safe harbor, the standard promulgated in Rev. Rul. 77-454 is the safer approach.

Since the actuarial value of the \$103,047 annual annuity is \$1,000,000, the question

arises whether the IRS was justified in Rev. Rul. 77-454 in ignoring this objective actuarial standard and using its more pragmatic approach. Interestingly, the Rev. Rul. 77-454 approach was rejected in *Shapiro Est. v. Comr.*⁸⁰ The Tax Court refused to allow the IRS to deviate from its own actuarial tables, finding that to do so would contravene the fundamental purposes and functions underlying the actuarial tables. The Tax Court went on to say that one is justified in ignoring the actuarial tables only when their use will violate reason, and that absent an unreasonable result, the actuarial tables must be used.

The court in *Shackleford v. U.S.*⁸¹ had to value the right to an annuity arising from a state lottery and applied the same standard used in *Shapiro Est.*, holding that departure from the actuarial tables is justified only where the tables do not produce a value that reasonably approximates fair value. Courts have long recognized that a table-produced valuation is not appropriate only when the result is unrealistic and unreasonable.⁸² Surprisingly, the *Shackleford* court found that the state's restrictions on the lottery annuity justified such a deviation. Using the same standard, the Tax Court, in *Gribauskas Est. v. Comr.*,⁸³ refused to depart from the actuarial tables. In *Gribauskas*, the decedent died owning a right to the remaining payments under a lottery he previously won. The estate reported the value of this annuity using general valuation principles for unsecured debt under § 2031. The IRS valued the payments under §7520 and disregarded the non-assignability factor. The Tax Court disagreed with *Shackleford* and held that the lottery annuity must be valued under §7520 because they were a series of fixed payments not tied to any specific asset or subject to any market fluctuations. The Tax Court refused to follow the decision in the district court's decision in the *Shackleford* case, stating that the district court's analysis in *Shackleford* would undercut the legislative purpose of §7520 to produce standardized actuarial valuations. The Tax Court went on to state that Regs. §20.7520-3(b), which provides exceptions to the general application of §7520, did not apply as there was no substantial risk that the payments would not be made.

In *Cook Est. v. Comr.*⁸⁴ the taxpayer owned a winning ticket from her state lottery, entitling her to a fixed amount payable in 20 annual installments. Under Texas law, lottery prizes payable in installments could not be transferred without a court order or converted to a lump sum at any time and there was no market in Texas for lottery prizes payable in installments. The taxpayer contributed her lottery annuity to a limited partnership. In valuing her limited partnership interest on her estate tax return, the Tax Court held that the lottery annuity must be valued under the actuarial tables rather than under general valuation principles, despite the fact that they were held in a limited partnership rather than individually. The Tax Court in *Cook* relied on its previous decision in *Gribauskas* and agreed with the IRS that a lack of a marketability discount was appropriate in valuing the partnership interests but was not grounds for altering the use of the annuity tables to value the underlying annuity owned by the partnership. The Tax Court held that the use of the actuarial tables did not produce a result so unrealistic and unreasonable that the tables were inapplicable, stating that:

The crucial issue is whether the valuation principles under the §7520 Regulations, which were intended to establish a brightline test for the valuation of annuities, should be used where there are significant factors which negate their use. In the *Shackleford* case, the district court noted that there were ten California lottery prize winners who attempted to transfer their awards and the prices at which they were able to sell their awards for were substantially discounted to reflect certain factors. The court in *Shackleford* concluded that the actuarial tables did not

reasonably approximate the fair market value of the lottery payments because California's statutory anti-assignment restriction reduced the fair market value.

CONCLUSION

Despite the obvious attractions of the deferral afforded the seller, the private annuity transaction is not beneficial in the context of the family's larger financial plan, due to the income tax treatment to the purchaser. Thus, over the long term, the advantage from the deferral is overwhelmed by the negative income tax consequences.

Footnotes

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¹See text at notes 65-75, below.

²Under *Crane v. Comr.*, 331 U.S. 1 (1947), non-recourse financing is part of the purchaser's cost basis. And, seller-provided financing between family members has been respected as a true debt. *Mayerson v. Comr.*, 47 T.C. 340 (1966), *acq.* Rev. Rul. 69-77, 1969-1 C.B. 59.

³In Rev. Rul. 55-119, 1955-1 C.B. 352, the IRS takes the position that the purchaser can include its private annuity obligation as part of its cost basis in the asset purchased even though a private annuity obligation is a contingent liability.

⁴Courts have consistently denied an interest deduction for the interest component inherent in the annuity payment, regarding each annuity payment as the acquisition cost of the asset purchased by the issuance of a private annuity. *Bell v. Comr.*, 76 T.C. 231 (1981), *aff'd*, 668 F. 2d 448 (8th Cir. 1982).

⁵For purposes of this article, the selling senior family member (or trust) will be referred to as "Senior" and the purchasing junior family member (or trust) will be referred to as the "Purchaser" or as the "Trust for Junior Family Members."

⁶If Senior's grantor trust is a 100% shareholder in an S corporation, or a 99% limited partner in a partnership, a sale by Senior to his controlled entity is a taxable sale despite the fact that Senior is deemed to be the income tax owner of the purchasing entity under the grantor trust rules. Under Regs. §1.707-3(a)(3) and (f) *Example 1*, a transfer may be a sale only in part if the amount paid is less than the fair market value of the property. Under Regs. §1.707-5(a)(1) and (f) *Example 1* a transfer of property subject to a liability is a disguised sale only to the extent that a share of the liability is shifted to other partners. The grantor trust provisions (§§671-678) do not apply related party or attribution rules similar to those found in the income tax area, §§267(b) and (c), 318, 453(f)(1) and 707(b) and the related party rules used in the gift taxes under §2701(e)(3). In the absence of specific statutory authority, it is the author's view that a sale by a grantor to an entity owned by a grantor trust should not be treated as a sale to the grantor trust.

⁷§72(b)(1); Regs. §1.72-4.

⁸§72(c)(1); Regs. §1.72-6.

⁹§72(b)(1); Regs. §1.72-3.

¹⁰See Regs. §1.72-9.

¹¹§72(c)(3), Regs. §1.72-5.

¹²§ 72(b)(3)(A); H.R. Rep. No 426, 99th Cong., 1st Sess. 731 (1985); S. Rep. No. 313, 99th Cong. 1st Sess. 607 (1986). No deduction for unrecovered basis is permitted if the annuitant dies before the annuity starting date.

¹³§72(b)(2). Prior to 1987, the annuitant could exclude a portion of all annuity payments, including the mortality gain payments, and no deduction was permitted for unrecovered basis if there was a mortality loss. There was previously a conflict between Rev. Rul. 69-74, 1969-1 C.B. 43, and Regs. §1.1011-2(c) *Example (8)* about what happened if the selling family member lived beyond the actuarial period.

¹⁴Rev. Rul. 69-74, 1969-1 C.B. 43. The IRS revoked its earlier position in Rev. Rul. 239, 1953-2 C.B. 53, where it applied the open transaction approach and allowed all principal payments to be first a recovery of basis. Rev. Rul. 55-119, above note 3, deals with the family buyer's basis.

¹⁵*Cf. Fehrs Finance Co. v. Comr.*, 487 F.2d 184 (8th Cir. 1983), *cert. den.* 416 U.S. 938 (applying § 304 to a redemption through a related corporation with the price paid in the form of a private annuity).

¹⁶Rev. Rul. 69-74, 1969-1 C.B. 43; GCM 39503, Issue (2)(C)(I)(a) (May 7, 1986); see Regs. §1.1011-2(c) *Example (8)*.

¹⁷See *Bell Est. v. Comr.*, 60 T.C. 469 (1973); *212 Corp. v. Comr.*, 70 T.C. 788 (1978); but see PLR 8102029 (Oct. 14, 1980) (applying traditional private annuity sale analysis to basis determination in a secured private annuity sale without comment).

¹⁸GCM 39503, Issue (2)(C)(1)(a) (May 7, 1986).

¹⁹See, e.g., *Dix v. Comr.*, 392 F.2d 313 (4th Cir. 1968); GCM 39503, Issue (2)(C)(3). See *Rye v. U.S.*, 25 Cl. Ct. 592, 92-1 USTC ¶150,186 (Cl. Ct. 1992), denying an interest deduction even though the seller reported the transaction as an installment sale. The court in *Rye* explicitly stated that there is no need for symmetry between the buyer and the seller.

²⁰Rev. Rul. 55-119, above note 3; GCM 39503, Issue (2)(C)(2)(a). As the buying family member makes further payments, they are added to basis, apparently without regard to fair market value of the property. This converts the excess payment, a substantial part of which represents the time value of money, into a capital loss on disposition of the family business or financial assets by the buyer.

²¹§1275(a)(1)(B) (debt obligation does not include amounts taxed as annuities). In GCM 39503 and PLR 9009064 (Dec. 8, 1989), the IRS indicated that it will continue to apply the § 72 annuity rules instead of the §453 installment method to private annuity sales. In *Rye v. U.S.*, above note 19, the court applied the §72 annuity rules to a private annuity sale.

²²*Bell v. Comr.*, above note 4.

²³Rev. Rul. 55-119, above note 3; GCM 39503, Issue (2)(C)(2)(a).

²⁴Rev. Rul. 55-119, above note 3.

²⁵*Id.*

²⁶See Leimberg, Johnson, Doyle and Kurlowicz, "Sections 2701-2704: Good Motives But A Tough Law To Follow," 16 *Tax Mgmt. Estates, Gifts & Trusts J.* 83, 88 (1991).

²⁷Regs. §1.1275-1(b).

²⁸§72(b)(1).

²⁹§72(c)(1).

³⁰§72(c)(3).

³¹§72(c)(3)(B).

³²Regs. §1.72-9, Table V.

³³§72(c)(4).

³⁴Regs. §1.72-9, Table V.

³⁵See H.R. Rep. No. 1042, 96th Cong., 2d Sess. 10 (1980); S. Rep. No. 1000, 96th Cong., 2d Sess. 12 (1980).

³⁶Rev. Rul. 2004-106, 2004-49 I.R.B. 893.

³⁷Regs. §1.72-9, Table V.

³⁸§108(e)(5).

³⁹See GCM 39,503 Issue (1). Rev. Rul. 55-119, above note 3; Rev. Rul. 69-74, above note 14. At the time Rev. Rul. 69-74 was issued, the annuity rules under § 72 permitted the indefinite use of the exclusion ratio, thereby permitting an annuitant to continue to exclude from taxation a portion of all annuity payments as the investment in the contract even though he had previously recovered his entire investment in the contract. Effective for annuities starting after December 31, 1986, § 72(b)(2) eliminated this so-called mortality gain. The discrepancy between Rev. Rul. 69-74, treating the seller's basis in the property sold as his investment in the contract, and Regs. §1.1011-1(b) *Example (8)*, treating the value of the property sold as the investment in the contract, no longer has any tax significance because of §72(b)(2) which precludes the use of the exclusion ratio once the entire basis is recovered.

⁴⁰Rev. Rul. 55-119, above note 3.

⁴¹*Id.*

⁴²*Dix v. Comr.*, above note 19; *Rye v. U.S.*, above note 19; *Bell v. Comr.*, above note 4 (1981). Under §1275(a)(1)(B)(i), the OID and unstated interest rules do not apply. For the seller, the annuity rules under §72 accomplish the same objective as the imputed interest rules under §1274. Under §72, the seller treats a portion of each payment as "annuity income." This is in effect the interest component.

⁴³In *Bell Est. v. Comr.*, above note 17, the court sanctioned the use of the estate and gift tax tables in valuing an annuity obligation under Rev. Rul. 55-119 for determining the buyer's tentative basis.

⁴⁴*Actuarial Tables Book Aleph*, Publication 1457 (July 1999).

⁴⁵By using a 16.0 year life expectancy under §72, the seller will end up recovering his basis over a longer term than the 13.9 year life expectancy used to compute the amount of the annual annuity payment. In other words, the recovery of basis is over a 16.0 year period instead of over 13.9 years. The 16.0 years is adjusted for the frequency of payment if less often than quarterly. Regs. §1.72-5(a)(2)(i).

⁴⁶Once basis is fully recovered, all subsequent payments are annuity income. §72(b)(2). Had S died after receiving 16 annual annuity payments, the total payments would have been \$16,487,536, an amount almost exactly the same as made under a 16-year, self-amortizing installment note.

⁴⁷Had an interest deduction been allowed equal to the annual annuity income the seller reported, the tentative basis would not have exceeded \$10,000,000 until after 16 years.

⁴⁸The buyer's basis in the shares purchased begins to exceed the \$10,000,000 value of the shares by the tenth annual payment.

⁴⁹See *Arrowsmith v. Comr.*, 344 U.S. 6 (1952).

⁵⁰§72(b)(3)(A).

⁵¹Although the IRS takes the position that the purchaser's annuity obligation is included in basis, Rev. Rul. 55-119, above note 3, its position is inconsistent with the treatment of contingent liabilities in general. *Albany Car Wheel Co. v. Comr.*, 40 T.C. 831 (1963). A fundamental principle of income taxation allows the purchaser to include in basis any fixed liability incurred as part of the acquisition of the asset. *Crane v. Comr.*, 331 U.S. 1 (1947); Regs. §1.1001-2(a).

⁵²Compare §453(e) which requires S to accelerate any gain deferred under the installment method if the related party sells the asset within two years.

⁵³This is consistent with *Arrowsmith v. Comr.*, 344 U.S. 6 (1952). Had the asset previously disposed of by the purchaser been held as a non-capital asset at the time of disposition, the loss attributable to annuity payments in excess of tentative basis would be an ordinary loss.

⁵⁴If the seller was reporting an ordinary gain, the financial benefit of the deferral is increased as the 35% ordinary income rate exceeds the 15%, 20%, or 25% capital gains rates. And, the purchaser's loss, which can be taken only when the aggregate of annuity payments exceeds tentative basis, would be an ordinary loss instead of a capital loss. In determining the capital gains taxes paid in Examples 10, 11 and 12, the 15% rate on long-term capital gains returns to 20% in 2009.

⁵⁵1955-1 C.B. 352.

⁵⁶Regs. §§1.483-4 and 1.1275-4(c), T.D. 8674 (6/11/96).

⁵⁷ $20\% \times \$5,972,301 = \$1,194,460$.

⁵⁸If all 8.6% of investment income were a capital gain, then the \$1,644,320 detriment illustrated in Examples 10, 11 and 12 would be reduced to a \$1,112,252 detriment.

⁵⁹Using the same assumptions from Example 5, but using an individual age 10 as the annuitant measuring life reduces the overall financial detriment to \$753,578.

⁶⁰*Bell Est. v. Comr.*, above note 17; *212 Corp. v. Comr.*, above note 17; cf. Regs. §1.83-3(e); GCM 39503 (Issue (2)(c)(1)(a)).

⁶¹S. Rep. No. 96-1000, 96th Cong. 2d Sess. at 22 (1980), 1980-2 C.B. at 496.

⁶²Regs. §1.1275-4(c).

⁶³See S. Rep. No. 96-1000, above note 61, 1980-2 C.B. at 506.

⁶⁴As adjusted in Regs. §1.72-5 (a)(2)(1) if the payments are less frequent than quarterly.

⁶⁵There may be a purchase price adjustment under § 108(e)(5) if the value of the obligation at death is less than its face amount and the buyer is unrelated to the seller.

⁶⁶§691(a)(5)(B).

⁶⁷§453(i).

⁶⁸§453(g).

⁶⁹§453(b)(2) and (1).

⁷⁰§453A(d).

⁷¹§453(f)(4).

⁷²§453(k) (2).

⁷³§§483(c)(3) and 1275(a)(1)(B).

⁷⁴§453(h).

⁷⁵§453B(h).

⁷⁶1977-2 C.B. 351.

⁷⁷If the annuity payments are less frequent than quarterly, an adjustment is required by Regs. §1.72-5(a)(2)(i). For a 70-year-old individual, the adjustment for an annual annuity is -0.5 years. Thus, the 16.0-year life expectancy for a 70-year old is reduced to 15.5 years for determining the "exclusion ratio."

⁷⁸See Hatcher & Manigault, "Using Beneficiary Guarantees in Defective Grantor Trusts," 92 *J. Tax'n* 152 (2000).

⁷⁹The joint life expectancy of two individuals, both age 70, is 18.4 years under Table 90CM and 20.6 years under Regs. §1.72-9 Table V.

⁸⁰66 TCM 1067 (1993).

⁸¹*Shackleford v. U.S.*, 262 F.3d 1028 (9th Cir. 2001).

⁸²*O'Reilly v. Comr.*, 973 F.2d 1403, 1407 (8th Cir. 1992), and *Weller v. Comr.*, 38 T.C. 790, 803 (1962).

⁸³116 T.C. 142 (2001).

⁸⁴82 TCM 154 (2001), *aff'd*, 349 F.3d 850 (5th Cir. 2003).