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February 15, 2007

The Honorable Mark W. Everson
Commissioner of Internal Revenue
Internal Revenue Service
Room 5226
1111 Constitution Avenue NW
Washington, DC 20224

Re: Comments Concerning Proposed Regulations Relating to Exchanges of
Property for an Annuity

Dear Commissioner Everson:

Enclosed are comments concerning proposed regulations relating to exchanges of property for an annuity. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

Enclosure

Cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
Michael J. Desmond, Tax Legislative Counsel, Department of the Treasury

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**COMMENTS CONCERNING PROPOSED REGULATIONS
RELATING TO EXCHANGES OF PROPERTY FOR
AN ANNUITY (PROP. REG. §§ 1.72-6(e) and 1.1001-1(j))**

These comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these comments was exercised by Kirk Van Brunt of the Committee on Insurance Companies. Substantive contributions were made by Susan Seabrook, Joseph F. McKeever, and Jean Baxley. The comments were reviewed by Joel Zychick of the Section of Taxation's Committee on Government Submissions. The comments were also reviewed by Peter J. Connors, Council Director for the Committee on Insurance Companies.

Although the Members of the Section of Taxation who participated in preparing these comments and/or other member of the Section of Taxation have clients who might be affected by the federal income tax principles addressed by these comments, no such member (or the firm or organization to which such member belongs) has been engaged in by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: February 14, 2007

EXECUTIVE SUMMARY

These comments relate to proposed Treasury Regulations (the “Proposed Regulations”) issued under sections 72 and 1001 of the Internal Revenue Code of 1986, as amended (the “Code”), relating to exchanges of property for an annuity contract.¹ Although applicable to both commercial and privately issued annuities, the primary impact of the Proposed Regulations will be on privately issued annuities.

The Proposed Regulations would amend the Regulations promulgated under section 1001 to provide that, with certain exceptions, if a transferor exchanges property for an “annuity contract,” the transferor is treated as receiving property in an amount equal to the fair market value of the annuity contract, as determined under section 7520. The Proposed Regulations would also amend Regulation section 1.72-6, relating to the definition of “investment in the contract,” to provide that in the case of an annuity contract received in exchange for property, the “aggregate amount of premiums and other consideration paid” for such an annuity would equal the amount realized in the exchange that is attributable to the annuity, *i.e.*, the fair market value of the annuity contract as determined under section 7520. In connection with finalizing the Proposed Regulations, the Service would also declare obsolete Rev. Rul. 69-74. The Proposed Regulations would be generally effective for exchanges occurring after October 18, 2006, although that date would be extended to exchanges occurring after April 18, 2007, if certain conditions are met.

The principal effect of the Proposed Regulations would be to require the transferor of property in a privately issued annuity transaction to recognize gain or loss at the time of the transaction in an amount equal to the difference between his adjusted basis in the transferred property and the fair market value of the annuity contract.

We believe the Proposed Regulations are correct in requiring full recognition of gain or loss at the time property is transferred, subject, however, to the Department of Treasury (the “Treasury”) and the Internal Revenue Service (the “Service”), providing relief from the hardship this treatment may impose on individuals and other cash method taxpayers. We recommend this relief take the form of clarifying that a privately issued annuity transaction is eligible for treatment as an installment sale, subject generally to the rules and regulations under sections 453, 453A and 453B. If this recommendation is adopted, we would further recommend the following amendments to the regulations under those sections:

1. Mechanical Operation of the Installment Method in General. – We recommend a simple method for applying the installment method to a privately issued annuity contract, and coordinating this method

¹ Unless otherwise indicated, all section references in these comments refer to the Code or the Treasury regulations (“Regulations”), as the context requires.

with the operation of section 72. An example of how our proposed method would operate is attached to these comments.

2. Treatment of the Long-Lived/Short-Lived Annuitant. – We also address how the installment sale rules and the rules under section 72 should apply in the event that the annuitant under a privately issued annuity dies before reaching his or her assumed life expectancy, or lives beyond his or her assumed life expectancy.
3. Clarification of the Term “Payment.” – We recommend clarifying that the term “payment,” as defined in section 453(f)(3) and the regulations thereunder, does not include the receipt of an annuity contract.
4. Amendment of Regulation Section 1.453-1(c). –We recommend amending the contingent sale rules to conform to the method for applying the installment sale rules to privately issued annuity contracts, as described above. At a minimum, the current reference in the regulations to a basis recovery period of 15 years should be changed to a recovery period equal to the life expectancy of the annuitant under a privately issued annuity contract.
5. Deductibility of “Interest.” – We also recommend that the Proposed Regulations or, separately, the Treasury and the Service, clarify that even though privately issued annuity transactions are being treated as installment sales, these transactions do not involve indebtedness and thus do not give rise to interest income or deductions.
6. Clarification of Section 453B(f). – We further recommend that the Proposed Regulations or, separately, the Treasury and the Service, clarify that the termination of a privately issued annuity contract, which does not provide for a maximum sale price, will not be treated as a transfer of an obligation under sections 691(a)(2) and 691(a)(5). Thus, the estate of the decedent-annuitant does not recognize gain upon the termination of such a privately issued annuity contract.
7. New Proposed Regulation Project under Section 453, et. al. Finally, although we are making a number of recommendations relating to the application of the installment sale rules to privately issued annuities in respect to the Proposed Regulations, there likely will remain other substantive and technical considerations that will need to be addressed. Accordingly, we further recommend that the Treasury and the Service open a new proposed regulation project under sections 453, 453A, and 453B, and solicit comments on the

application of the installment sale rules to privately issued annuities.

In addition to comments relating to the application of the installment sale rules, we also are providing comments on (i) annuities issued by charities in bargain sale transactions, and (ii) the effective date of the Proposed Regulations. Specifically:

8. Exclude Charity Issued Bargain Contracts. Retention of the deferral of gain rule in Regulation section 1.1011-2(c), example 8, for annuities issued by charities in bargain sale transactions contradicts the repeal of such deferral for other privately issued annuity contracts. Accordingly, unless there is a tax policy rationale specific to charities that would justify this special rule (in which case, we think it is incumbent on the Treasury and the Service to plainly articulate this policy), then we recommend that this exclusion of charity-issued annuity contracts from the ambit of the Proposed Regulations be eliminated in the final regulations. Retention of the current rule will only serve to undermine the legitimacy of the general rule in the Proposed Regulations.
9. Revise Transitional Relief. We recommend that the general effective date of the Proposed Regulations be extended to April 18, 2007, to accommodate taxpayers who relied in good faith on Rev. Rul. 69-74 and Rev. Rul. 62-136. However, we appreciate and concur in the desire not to provide transitional relief for abusive privately issued annuity transactions. Currently, the Proposed Regulations set out three conditions for obtaining favorable transition relief, which, in our view, do not appropriately distinguish between legitimate and abusive transactions. We recommend these three conditions be revised and restated in a manner that more closely tracks the Service's abuse concerns. We are providing below suggested effective date language to this effect
10. Exclude Commercial Annuities. The Proposed Regulations should have little practical impact on commercial annuities, which generally are not issued in exchange for property. Thus, we are not commenting on how the Proposed Regulations would apply to such annuities, with one exception. The one exception is that an annuity issued by an insurance company is not subject to valuation under section 7520, and so we would recommend clarifying that valuation under section 7520 is required only to the extent that that section would otherwise apply.

COMMENTS

I. INTRODUCTION

A. Summary of The Proposed Regulations

On October 18, 2006, the Treasury and the Service issued the Proposed Regulations under sections 1001 and 72, dealing with exchanges of property for annuity contracts.² The Proposed Regulations by their terms apply with respect to any type of annuity contract, whether it be a commercial annuity or a so-called privately issued annuity. However, the primary impact of the Proposed Regulations will be on privately issued annuities. We anticipate that they will have no material effect on the current tax treatment of commercial annuity contracts.

The Proposed Regulations would make two basic changes. First, the Proposed Regulations would amend the Regulations under section 1001 to provide that if a transferor exchanges property for an “annuity contract,” the transferor is treated as receiving property in an amount equal to the fair market value of the annuity contract.³ The fair market value of the annuity contract is its value, as determined under section 7520.⁴ The term “annuity contract” for this purpose would not include an annuity contract (a) treated as a debt instrument subject to the original issue discount rules, or (b) received from a charitable organization in a bargain sale governed by Regulation section 1.1011-2.⁵

Second, the Proposed Regulations would amend the Regulations under section 72 defining “investment in the contract.” Regulation section 1.72-6(a) defines “investment in the contract” generally as equal to the “aggregate amount of premiums and other consideration paid” for the contract, subject to certain adjustments. The Proposed Regulations would supplement the existing definition by adding a new subsection applicable to an annuity contract received in an exchange subject to Proposed Regulation section 1.1001-1(j), described above. The “aggregate amount of premiums and other consideration paid” for such an annuity would equal the amount realized in the

² 71 FED. REG. 61441 (Oct. 18, 2006).

³ Prop. Reg. § 1.1001-1(j)(1).

⁴ *Id.*

⁵ *Id.* If an “annuity contract” is treated as a debt instrument subject to the “OID” rules, the amount realized is generally the issue price of the contract. *See* Reg. § 1.1001-1(g). In the case of a charity-issued annuity contract subject to the bargain sale rules in Reg. § 1.1011-2, gain is realized equal to the “present value” of the annuity contract, but such gain is recognized ratably over the life expectancy of the transferor. *See* Reg. § 1.1011-2(c), example 8.

exchange that is attributable to the annuity, *i.e.*, the fair market value of the annuity contract as determined under section 7520.⁶

The foregoing changes are proposed to be effective generally for exchanges of property for an annuity contract that occur after October 18, 2006.⁷ However, this proposed effective date is delayed until April 18, 2007 for exchange transactions that meet three conditions: (a) the issuer of the annuity contract is an individual; (b) the obligations under the annuity contract are not secured, either directly or indirectly; and (c) the property transferred in exchange for the annuity contract is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange.⁸

Upon finalization of the Proposed Regulations, the Treasury and the Service also propose to declare Rev. Rul. 69-74, 1969-1 C.B. 43 obsolete, effective contemporaneously with the effective date of the Proposed Regulations, as finalized.⁹

Three basic reasons were provided in the Notice of Proposed Regulations as the basis for these changes in the taxation of exchanges of property for annuity contracts. First, the Treasury and the Service are concerned that taxpayers are “inappropriately” avoiding or deferring gain on the exchange of highly appreciated property in privately issued annuity transactions. Second, the Department and the Service believe that neither the “open transaction” approach of *Lloyd v. Commissioner*, nor the ratable gain recognition mechanism of Rev. Rul. 69-74, clearly reflect income. Rather, it is the Government’s view that an annuity contract is capable of valuation and thus full gain recognition is called for under section 1001. Third and finally, the Department and the Service believe that a person who transfers property for an annuity contract should be taxed in a manner consistent with a person who first sells the property and then uses the proceeds to purchase an annuity contract.¹⁰

B. Background on Privately Issued Annuity Contracts

In taxing transactions involving “annuity contracts,” courts and the Service have distinguished between annuity contracts issued by insurance companies, which are in the business of managing the mortality risk involved in such contracts (“commercial annuities”), and annuity contracts issued by other parties (“privately issued

⁶ Prop. Reg. § 1.72-6(e)(1).

⁷ Prop. Reg. § 1.1001-1(j)(2)(i); Prop. Reg. § 1.72-6(e)(2)(i).

⁸ Prop. Reg. § 1.1001-1(j)(2)(ii); Prop. Reg. § 1.72-6(e)(2)(ii). For this purpose, a disposition includes, without limitation, a transfer to a trust (whether a grantor trust, a revocable trust, or any other trust) or to any other entity even if it is solely owned by the transferor. *Id.*

⁹ 71 FED. REG. at 61,443.

¹⁰ 71 FED. REG. at 61,442-43.

annuities”).¹¹ These “other parties” may be individuals, trusts, charities, or other persons, but the common denominator in this context is that these private issuers are not engaged in the insurance business.¹² To constitute an “annuity contract,” and not a debt instrument, a contract issued by a private party generally must provide for periodic payments over the life of at least one individual.¹³

Under current law, the primary income tax distinction between commercial and privately issued annuities relates to the taxation of the person who transfers property to the issuer in exchange for the annuity contract. In the case of a commercial annuity, the transaction is treated as involving a disposition of the property that causes the purchaser to recognize gain or loss, based on the difference between the purchaser’s adjusted basis in the property and the fair market value of the annuity.¹⁴ In the case of a privately issued annuity, however, gain or loss recognition is deferred. Originally, recognition of gain or loss was deferred until the transaction “closed” —*i.e.*, when the purchaser had received sufficient annuity payments to recover his basis or investment or, if earlier, when the annuity terminated.¹⁵ Subsequently, in Rev. Rul. 69-

¹¹ These non-insurance company issuers have been commonly referred to as “private” issuers, “amateur annuity writers,” “free lancers,” *etc.* See, e.g., *Steinbach Kresge Co. v. Commissioner*, 33 F. Supp. 897, [536] (D. NJ 1940). The Service further subdivides the universe of private issuers into (i) “corporations, trusts, funds or foundations”, which issue annuity contracts from “time to time,” see Rev. Rul. 62-136, 1962-2 C.B. 12, and (ii) persons who do not issue annuity contracts from “time to time.” The Fourth Circuit Court of Appeals has interpreted “time to time” issuers as embracing “only those organizations which write enough annuity contracts to obtain a good spread of the actuarial risk.” *Dix v. Commissioner*, 393 F.2d 313, 316 (4th Cir. 1968).

¹² It should be noted that in order to constitute an “annuity contract” for federal tax purposes, the contract—whether it be a privately issued annuity or a commercial annuity—must provide for the minimum distributions required by section 72(s). Commercial annuities typically contain specific language designed to ensure compliance with section 72(s); privately issued annuities generally do not have such language. However, generally the privately issued annuity takes the form of an immediate life annuity, and as such, the contract often in fact provides for payments that comply with section 72(s).

¹³ See Reg. § 1.1275-1(j)(2)(i)(A).

¹⁴ The authority for the treatment of commercial annuities is the general rule in section 1001(b), coupled with the fact that none of the authorities modifying this general rule extend to commercial annuities. On the application of section 1001(b) (and its predecessor statutes) to property-for-annuity transactions, see, generally, GCM 1022, VI-1 C.B. 12 (1927); *Guaranty Trust Co. of New York v. Commissioner*, 15 B.T.A. 20 (1929). See also Rev. Rul. 62-136, 1062-2 C.B. 12.

¹⁵ See, e.g., *Lloyd v. Commissioner*, 33 B.T.A. 903 (1936), *nonacq.*, XV-2 C.B. 39 (1936), *nonacq. withdrawn and acq.*, 1950-2 C.B. 2; Rev. Rul. 239, 1953-2 C.B. 53.

54,¹⁶ the Service crafted an accounting method for privately issued annuity whereby gains or losses are recognized ratably as annuity payments are received. The key point, however, is that full recognition of gain or loss is not required at the time of sale.

Why the historic distinction between commercial and privately issued annuities? Privately issued annuities involve two distinct types of contingencies: (1) transferor mortality risk (how long will the transferor live), and (2) transferee credit risk (will the transferee be able to perform under the contract). These risks prompted courts early on to declare that the annuity contract had no fair market value, relying on the so-called open transaction doctrine created by the Supreme Court in *Burnett v. Logan* in 1931.¹⁷ The focus of these early cases, however, was not principally mortality risk, which could be quantified through published mortality tables, but on credit risk.¹⁸ As the court in *Lloyd* described it:

But here a new element enters the computation, the uncertainty as to whether or not the one agreeing to make payments will be able to make them as agreed when the time for payment actually arrives. This difficulty might not be so great in the case of a sound insurance company regularly engaged in granting annuities or, perhaps, in the case of a bank.¹⁹

¹⁶ 1969-1 C.B. 43.

¹⁷ See, e.g., *Commissioner v. Kann's Estate*, 174 F.3d 357, 358 (3d Cir. 1948) (“[W]here both the annuitant’s life span and the obligor’s ability to pay are uncertain no fair market value should be ascribed to the contract or obligation.”). Other early cases adopting the open transaction approach of the *Lloyd* case are: *Hommel v. Commissioner*, 7 T.C. (1946), *nonacq.*, 1947-1 C.B. 5, *nonacq. withdrawn and acq.*, 1950-2 C.B. 2; *Hill's Estate v. Maloney*, 58 F. Supp. 164 (D. NJ 1944); *Evans v. Rothensies*, 114 F.2d 938 (3d Cir. 1940); *Deering v. Commissioner*, 40 B.T.A. 984 (1939), *nonacq.*, 1940-1 C.B. 6, *nonacq. withdrawn and acq.*, 1950-2 C.B. 2. See, generally, M. Paul Andro, *Non-Commercial Annuities—Income Tax Consequences to the Transferor Who Exchanges Property in Return for an Annuity*, 9 TAX L. REV. 87 (1953) (reviewing the early caselaw).

¹⁸ Paul A. Wallace, Jr., *Taxation of Private Annuities*, 40 B.U. L. REV. 349, 354 (1960) (making this observation).

¹⁹ 33 B.T.A. at 905. Cf. *Bedell v. Commissioner*, 30 F.2d 622, 624 (2d Cir. 1929) (“[I]t is absurd to speak of a promise to pay a sum in the future as having a ‘market value,’ fair or unfair.”).

Curiously, despite focusing on credit risk, courts have not delved into the actual financial circumstances of the obligor. For example, in *Lloyd*, the obligor was actually quite wealthy. See *Estate of Kann v. Commissioner*, T.C. Memo No. 226 (1947), *aff'd* 174 F.2d 357 (3d Cir. 1948) (“Both the annuitant’s life span and the other party’s ability to pay are uncertain and contingent, and this seems to be essentially a matter of law, independent of actual proof of the financial capacity of the one making the promise.”).

This focus on credit risk—the distinction between a “sound insurance company” and “amateurs” —touches on a more fundamental issue that has long proved troubling. How should the tax law take into account a bare, unsecured promise to pay money in the future?²⁰ At an intuitive level, the early privately issued annuity cases do resonate: if Grandfather sells Blackacre to Peter the profligate—his unemployed and dissolute grandson—in exchange for Peter’s promise to make payments for upwards of 20 years or more, is Peter’s promise actually worth much more than the paper it is printed on? Probably most would say ‘no.’

The Service initially disagreed with the *Lloyd* case and its progeny, before ultimately acquiescing²¹ and then officially adopting open transaction treatment in Rev. Rul. 239.²² However, despite its acquiescence, the Service remained uneasy with open transaction treatment and several attempts were unsuccessfully made to overturn the doctrine legislatively, as applied to privately issued annuities.²³ The Service also began to back away from Rev. Rul. 239, issuing Rev. Rul. 62-136,²⁴ for example, which denied open transaction treatment where the issuer of the annuity was an entity that “from time to time” issued annuity contracts (albeit, not a commercial insurance company). Finally, in Rev. Rul. 69-74, the Service created a new set of rules for taxing privately issued annuity contracts, melding the section 72 exclusion with installment sale concepts.

²⁰ In the context of section 1001(b), the law has evolved to the point today where credit risk is generally irrelevant. A promise to pay will be valued according to its terms and taxed, regardless of how speculative or illiquid the promise may be. *See, e.g., Campbell v. U.S.*, 661 F.2d 209 (Ct. Cl. 1981); *Warren Jones Co. v. Commissioner*, 524 F.2d 788 (9th Cir. 1975). In contrast, in the context of an exchange of services for a promise to pay, the promise is ignored if it is unfunded and unsecured. *See* Reg. § 1.83-3(e). Similarly, under the cash method of accounting, the mere receipt of a promise to pay in the future is not an amount includible in gross income unless it is the “equivalent of cash.” *See, e.g., Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961). ITA 1996-10 (Mar. 12, 1996).

²¹ *See* note 17, *supra*.

²² 1953-2 C. B. 53

²³ In connection with the 1954 Code, the House of Representatives initially proposed equalizing the taxation of privately issued and commercial annuities, but the Senate rejected the proposal. *See* H.R. Rep. No. 83-1337, § 1241 (1954). The Treasury proposed a similar legislative change in 1963, but the proposal was never reported out of Committee. *See* Dept., Technical Memorandum submitted to the House Ways & Means Comm., at 81 (Feb. 6, 1963). Subsequently, the Service let it be known that it was no longer issuing private rulings on privately issued annuity transactions involving transfers of highly appreciated property. This no-ruling position was being adopted in advance of an expected regulatory change that would require the transferor to recognize the full amount of gain at the time of the transfer. *See* 18 ABA BULL. OF THE SECTION OF TAXATION, pt. 1, at 76 (Jan. 1965).

²⁴ 1962-2 C.B. 12.

Although criticized by commentators at the time it was issued,²⁵ Rev. Rul. 69-74 did bring a measure of stability to the tax treatment of privately issued annuities. It ameliorated some of the Service's concerns about the magnitude of deferral available under the open transaction approach of Rev. Rul. 239, and to a certain extent it also addressed concerns about taxing persons upon the receipt of a bare, unsecured promise, particularly where that promise is contingent on the life of the obligee. Unlike property exchanged for a promise to pay that is not life contingent, as to which, the transferor as a general matter can seek refuge in the installment sale rules, taxation of the life contingent promise inherent in a privately issued annuity was an all or nothing proposition prior to Rev. Rul. 69-74. Gain was entirely deferred under the open transaction doctrine or, if that doctrine was inapplicable, gain was immediately recognized in its entirety; there was no middle ground. Rev. Rul. 69-74 provided a middle ground. Gain would be recognized, notwithstanding the fact the contingencies involved remained unresolved, but only ratably as actual cash was received. Rev. Rul. 69-74 created a quasi-installment sale method for the privately issued annuity. While not a perfect solution by any means, in retrospect Rev. Rul. 69-74 was a workable compromise of competing policies, a realpolitik solution for reconciling the theory that everything is capable of fair market valuation with the reality of Grandson Peter's promise.

Although the rules of Rev. Rul. 69-74 have now persisted for almost 40 years, concerns about tax abuse have grown in recent years, as the privately issued annuity has become an increasingly popular device for family transfers of appreciated property. Many of these transactions involve purported sales of property to a trust in exchange for an annuity promise from the trust. Sometimes the trust sells the property and reinvests the proceeds in income producing property to fund the annuity promise (sometimes investing in a commercial annuity contract no less), and sometimes the trust retains the property and uses income generated from the property to pay the annuity. Many variations on the private annuity trust exist; too many to describe here. However, the private annuity trust frequently has been used in an extremely tax aggressive manner. For example, in some cases, the taxpayer never really surrenders tax ownership of the property and thus there is no true sale for tax purposes. In other cases, the taxpayer has already negotiated the sale of the property to a third party and the private annuity trust is interposed at the last minute for the sole purpose of achieving tax deferral. In still other cases, the private annuity trust is merely an elaborate device for transferring property while retaining a life income interest in it. Understandably, the Service's position is that in all of these types of privately issued annuity cases, and others besides, the transaction should be characterized as abusive. However, not all privately issued annuity transactions are of this ilk. As the preamble to the Proposed Regulations acknowledges, property is sometimes exchanged for a privately issued annuity "for valid, non-tax reasons related to estate planning and succession planning for closely held businesses."²⁶

²⁵ See, e.g., Martin D. Ginsburg, *Taxing the Sale for Future Payment*, 30 TAX L. REV. 470, 576-87 (1975).

²⁶ 70 FED. REG. at 61,443.

The question is, given the perceived abuses that have been occurring in the privately issued annuity market, what is the best administrative response? On the one hand, a strong case can be made that the Service already has an ample arsenal of weapons to attack abuses in the privately issued annuity world: the step transaction doctrine; the substance over form principle; the assignment of income doctrine; the economic substance/business purpose test; section 2036, *etc.* Under this view, the Proposed Regulations are unnecessary and an overreaction; Rev. Rul 69-74 is not the problem and revoking it is not the solution. On the other hand, the Service's litigation track record in this area is good, but not great. More to the point, the abusive privately issued annuity transactions do seem to be proliferating at an alarming pace and the Service's efforts to police them do not appear to be having a significant deterrent effect. It would seem that taxpayers have won enough times in court that too few are paying any attention to the many cases where taxpayers have lost. Viewed in that light, revoking Rev. Rul. 69-74, and thereby turning off the spigot, as it were, is arguably the only way to stop the abusive transactions.

II. COMMENTS ON PROPOSED REGULATIONS

A. Full Recognition of Gain/Loss When Property is Transferred for a Privately Issued Annuity

Full recognition of gain or loss at the time when property is transferred for a privately issued annuity ("Full Recognition") creates a potential hardship for individuals and other cash method taxpayers, who may have to pay tax on gain well in advance of the time when the corresponding cash is actually received (if, indeed, cash is ever received). Subject to addressing this potential hardship, as suggested below (or in some other reasonable manner), we concur in and support the Service's decision in the Proposed Regulations to require "Full Recognition" for both commercial and privately issued annuities. We believe this approach is supported by sound tax policy and is consistent with section 1001(b) and the Regulations thereunder. Rev. Rul. 69-54 and the full open transaction approach of the *Lloyd* case before it, have long been viewed in this area as aberrational and it is well past the time when they should be abandoned.

In concurring with the approach of the Proposed Regulations, we note that the tax treatment of privately issued annuities has long suffered from an internal contradiction: a privately issued annuity possesses a readily determinable fair market for purposes of calculating investment in the contract²⁷ and/or the amount of capital gain realized on the exchange,²⁸ but at the same time the annuity's fair market value is claimed to be indeterminable for purposes of section 1001(b).²⁹ Despite judicial attempts

²⁷ See, *e.g.*, Reg. § 1.1011-2(c), example 8.

²⁸ See, *e.g.*, Rev. Rul. 69-74, principle (1).

²⁹ See, *e.g.*, *Est. of Bell v. Commissioner*, 60 T.C. 469, 476 (1973). This inconsistency has been justified, perhaps somewhat glibly, on the basis that "the sections are not concerned with the same matters." *212 Corp. v. Commissioner*, 70 T.C. 788, 807 (1978) (Faye, J., dissenting).

to rationalize this,³⁰ an inconsistency exists. If a privately issued contract can be valued for some purposes under the federal income tax laws, it should be considered as capable of being valued for all purposes. Thus, we concur with the Service that deferral of gain or loss recognition under section 1001(b) in the privately issued annuity context is unjustified and contrary to the statute and Regulations promulgated thereunder, as they have come to be interpreted at this time.³¹

Further, we concur with the Service that Full Recognition under section 1001(b) should apply regardless of the taxpayer's method of accounting. Even if the promise to pay represented by a privately issued annuity is not the equivalent of cash or does not bestow a current economic benefit on the taxpayer within the meaning of the relevant authorities under section 451, this should be irrelevant in applying section 1001(b) to the transaction. Outside the privately issued annuity context, the hardship of requiring Full Recognition for a cash method taxpayer transferring appreciated property in exchange for a promise to pay money in the future has been addressed by Congress and the Service in the installment sale rules in current section 453, *et seq.*, and the Regulations promulgated thereunder.

Having said all this, we nevertheless condition our support of the Proposed Regulations on a revision which appropriately addresses the hardship for individual and other cash method taxpayers in the privately issued annuity context. We accept, however, that any solution to this problem should be crafted outside of section 1001(b) (*e.g.*, by clarifying the installment sale rules) and not by reading into section 1001(b)—a special carve-out for privately issued annuity transactions.

³⁰ See, *e.g.*, *Lloyd*, *supra* note 15, 33 B.T.A. at 905.

³¹ Prior to *Warren Jones* and its progeny, one could fairly conclude that a cash equivalency requirement existed under section 1001(b) in determining the amount realized. See, *e.g.*, *Western Oak Building Corp. v. Commissioner*, 49 T.C. 365 (1968); *212 Corp.*, *supra* note 28, at 808 (Faye, J., dissenting). However, the weight of the authorities today would no longer seem to support that view.

B. Clarify the Installment Sale Rules to Include Privately Issued Annuity Transactions

1. In General

A transfer for property in exchange for a privately issued annuity contract frequently is an intra-family transaction, and, as such, the transaction may contain a gift component. Often, however, the parties do not intend to make gift and the transaction is structured as a simple sale of property. To the extent that the transaction does involve a bona fide sale (rather than a gift), it would seem to constitute an “installment sale” within the meaning of section 453(b)(1), since the transaction does provide for at least one payment after the close of the taxable year in which the disposition occurs.³² Although the payments under a privately issued annuity are contingent, since 1980 it is clear that contingent sale transactions can qualify as installment sales under section 453(b)(1).³³

Notwithstanding the foregoing, the Service has declined to treat certain types of privately issued annuity contracts as installment sales for purposes of section 453(b)(1), electing instead to tax them under the quasi-installment sale method set out in Rev. Rul. 69-74. However, the Service has recognized that some privately issued annuities should be taxable as installment sales. For example, in GCM 39503, the Service analyzed the tax treatment of a private annuity contract that provided for annual payments of \$10,000 until the seller died or until 10 payments had been made, whichever should occur first. If the seller’s remaining life expectancy exceeded 10 years, the Service concluded that the transaction should be taxable as an installment sale; if the seller’s remaining life expectancy was less than 10 years, the transaction should be taxable under Rev. Rul. 69-74.³⁴

³² See, e.g., Stephen F. Gertzman, FEDERAL TAX ACCOUNTING, ¶5.05[12][e] (2006) (“Technically, a private annuity may fit within the definition of a contingent price installment sale. As such, a private annuity may be subject to the contingent price installment sale regulations. However, this is not certain.”).

³³ The legislative history of the Installment Sales Revision Act of 1980 did not provide specific statutory rules for applying the installment sale rules to contingent payment sale transactions, but instead deferred to the Service to address the issue through regulations. See section 453(j)(2). The legislative history of the Act evidences a recognition on Congress’ part that a question exists about privately issued annuity transactions, but the issue was shunted aside with the statement: “Another technique used for intra-family sales involves the so-called ‘private annuity’ arrangement. This bill does not deal directly with this type of arrangement.” S. Rep. No. 96-1000, at 12n. 10 (1980); H.R. Rep. No. 96-1042, at 10n. 12 (1980). Apparently the bill does deal “indirectly” with private annuities, perhaps in the sense that it consigns the issue with the Service as one to be resolved through Regulations pursuant the authority given in section 453(j)(2).

³⁴ Amendments to the OID regulations in 2002 now require the annuitant’s life expectancy to be at least twice the maximum term in order for the contract to be an annuity contract and not a debt instrument. See Reg. § 1.1275-1(j)(6).

With the revocation of Rev. Rul. 69-74, we think that the analysis of GCM 39503 is no longer valid. In finalizing the Proposed Regulations, the Service should clarify that all privately issued annuities issued in bona fide property sale transactions will be treated as installment sales within the meaning of section 453(b)(1). Thus, in all such privately issued annuity transactions, the taxpayer will be required to report any gain on sale (but not losses) on the installment method of accounting, subject to the same rules, requirements, and limitations in sections 453, *et seq.*, that apply to any other installment sale.³⁵ The current installment sale rules are more than adequate to address any abuse concerns that the Service may have regarding the use of privately issued annuities to inappropriately defer gain recognition. We believe the regulatory authority granted to the Service in section 453(j)(2) to address contingent sale transactions provides ample authority to do this.

If privately issued annuity transactions are not treated as installment sales, as a practical matter these transactions will cease to occur, even though there is a general consensus that they do serve valid estate and succession planning purposes. In the event installment sale treatment is not available, these transactions will, instead, be structured as a self-canceling installment note or as a straight, fixed price installment sale. Those alternative transactions, however, lack the one crucial feature that the privately issued annuity offers: *income for life*. Only through the privately issued annuity transaction can the seller dispose of property and receive a lifetime income or annuity stream, and obtaining income for life is, in fact, a primary objective for many sellers as they are entering retirement. The self-canceling installment note and the straight installment sale necessarily entail a risk that the seller will outlive the income from the sale. We perceive no tax policy reason why taxpayers must surrender the ability to obtain income for life as the price of admission to installment sale treatment.

³⁵ Thus, for example, a privately issued annuity transaction would be subject to the 2-year rule in section 453(e). Similarly, like any other installment obligation, the privately issued annuity contract could be secured by a third party guarantee or standby letter of credit, as provided under Reg. § 15a.453-1(b)(3).

2. **Specific Recommendations Regarding the Application of the Installment Method of Accounting**

We recognize that simply stating that privately issued annuity contracts are subject to the installment sale rules in section 453, *et seq.*, is likely to raise a number of collateral questions. How the installment method of accounting should apply to a privately issued annuity transaction is not entirely obvious and free from debate. In addition, it would be necessary for the Service to make other conforming changes to the regulations under section 453 and section 453A to accommodate privately issued annuity contracts. In this regard, we make the following specific recommendations:

a. **Mechanical Operation of the Installment Method in General**

One reasonable way to apply the installment method to a privately issued annuity transaction, which we would recommend be adopted, would be as follows:

- Step 1: Calculate the fair market value of the privately issued annuity promise.
- Step 2: Compute sale gain by subtracting the seller's adjusted basis in the property from the fair market value of the privately issued annuity promise.
- Step 3: Compute the profit ratio. "Gross profit" (sale gain) divided by the "total contract price." The total contract price is the fair market value of the annuity computed in Step 1, *i.e.*, the "principal" amount of the obligation exclusive of any income on the contract amount.³⁶
- Step 4: Construct an installment payment schedule by allocating the total contract price ratably among the periodic payments scheduled to be received under the annuity, based on the annuitant's life expectancy, as determined under the life expectancy table in Regulation section 1.72-9.
- Step 5: For each annuity payment received, multiply the installment payment portion by the gross profit ratio. The result is taxable upon receipt as gain from the sale of property, the character of which may be long- or short-term capital gain.
- Step 6: The remaining portion of the annuity payment (net of the portion taxable as gain in Step 5) would be taxable in accordance with the rules of section 72. Specifically, each annuity payment is

³⁶ Note: one would not equate the "expected return," within the meaning of section 72(c)(3), with the total contract price.

multiplied by an “exclusion ratio” (equal to the “investment in the contract” (*i.e.*, the fair market value of the contract) divided by the “expected return”). The amount of each annuity payment that is not taxable, either as gain under Step 5 or as income under section 72, is excludable from tax as a return of basis.

An example of the calculations is attached as Example 1.

b. Treatment of the Long Lived/Short Lived Annuitant

The tax treatment of the parties to a privately issued annuity contract is based on an assumption about the life expectancy of the annuitant under the contract. Life expectancy, however, is an average derived from applying the law of large numbers to the actual mortality experience of a large class of individuals. It is not a prediction, *per se*, about how long any one individual will live. Indeed, almost by definition the actual remaining life span of any one individual will deviate to some degree from the mean life expectancy. This raises the question of how the installment method of accounting applies when the actual remaining life span of an individual turns out to be longer or shorter than the assumed life expectancy.

If an annuitant lives beyond the assumed life expectancy, he will receive payments beyond the time when he will have recognized all of the gain from the sale that was deferred under the installment sale rules. For example, if the life expectancy of an annuitant was 15 years and his actual remaining life was 20 years, the gain on the sale would have been fully recognized and taxed by the end of year 15. At this point, the annuitant is taxable on the additional annuity payments after year 15 solely by reference to section 72. Under section 72, since the annuitant will also have recovered his investment in the contract by the end of year 15, the entire amount of each remaining annuity payment will be taxable as ordinary income under section 72. This is obviously an inaccurate outcome; the annuitant has effectively accelerated recognition of sale gain and recovery of basis. However, presently, this inaccuracy is inherent in section 72, and cannot be avoided in any administratively reasonable way, and we would not propose any changes to address this situation.

On the other hand, if the annuitant dies prematurely, he will not have received all of the annuity payments that the tax laws assumed he would receive. Thus, there will exist unrecognized gain from the sale as well as unrecovered basis. In this situation, section 72(b)(3) provides that the annuitant is entitled to claim an ordinary loss for the amount of his unrecovered investment in the contract. We would recommend issuance of a regulation under section 72(b)(3), clarifying that in computing the amount of the loss deduction under section 72(b)(3), the amount of unrecovered investment in the contract is reduced by the amount of remaining unrecognized gain from the sale of property. The net amount remaining would then be an ordinary deduction under section 72(b)(3). The treatment of the short-lived annuitant is illustrated in Example 2 attached hereto.

c. Clarification of the Term “Payment”

Regulation section 1.453-1(b)(3)(i) should be amended to clarify that the term “payment” does not include the receipt of a privately issued annuity. Like many other contingent payment instruments, a privately issued annuity typically does not constitute indebtedness within any reasonable meaning of that term, and thus the existing language of Regulation section 1.453-1(b)(3)(i) is, we believe, inadequate. Although section 453(f)(3) does use the term “evidence of indebtedness,” we submit that the Service’s regulatory authority in section 453(j)(2) to adopt rules for contingent sales necessarily includes the authority to exclude a contingent payment instrument issued in such transactions from the definition of “payment.” The Service should exercise that authority to clarify that the term “payment” does not include a privately issued annuity.

d. Amendment of Regulation Section 1.453-1(c)

The contingent sale rules in Regulation section 1.453-1(c) should be amended to provide specific rules for privately issued annuities, the payments under which and the term of which are mortality contingent. This would include a contract that provided for periodic payments for the life of the annuitant. Currently, Regulation section 1.453-1(c)(4) provides for a recovery of basis over an arbitrary 15-year term, which, at a minimum, should be changed to the annuitant’s life expectancy.

e. Deductibility of “Interest”

The Service may wish to clarify the treatment of interest/original issue discount under privately issued annuity contracts. At least in the case of an annuity contract that simply provides for payments for the life of an annuitant, with no maximum or minimum price, this contract should not be treated as giving rise to interest income or deductions. Such a clarification would formally codify the Service’s view previously stated in the preamble to the regulations under section 1275 on the treatment of annuity contracts as debt instruments.³⁷

We have considered the possibility of treating a privately issued annuity contract as a debt instrument, but have concluded that that approach should be rejected for three reasons. First, although the definition of indebtedness has been greatly liberalized in recent years to encompass a broad range of contingent payment instruments, to treat an immediate life annuity contract as debt would be to expand the concept of indebtedness far beyond its current accepted boundaries. Second, such an approach would essentially read section 1275(a)(1)(B) out of Code; the Service considered the scope of section 1275(a)(1)(B) at length in the 1990s before finalizing the Regulations thereunder in 2002, and correctly concluded that purely life contingent

³⁷ See T.D. 8754, 1998-1 C.B. 647, 649.

instruments do not qualify as debt instruments.³⁸ We see no need to reopen that controversial subject again. Third and finally, since a fundamental theme of the Proposed Regulations is to equalize the treatment of commercial and privately issued annuities, to treat privately issued annuities as debt would be to venture onto the proverbial slippery slope at the bottom of which lies a rule treating all annuities as debt—a rule which would effectively eliminate section 72.³⁹ That obviously would take us well beyond the immediate task at hand of fixing privately issued annuity abuses.

f. Clarification of Section 453B(f)

Closely related to the privately issued annuity is the self-canceling installment note, which typically provides for payment of a specified sales price in installments. However, if the seller dies before the buyer has made all of the specified installment payments, the buyer's obligation to make such payments is extinguished. Although controversial, the Service's position is that the estate of the decedent-seller must recognize gain under sections 691(a)(2) and 691(a)(5), with respect to the future installment payments that were cancelled at death.⁴⁰

Unlike the self-canceling installment note, the privately issued annuity does not provide for a maximum selling price or a fixed number of installment payments, which is subject to cancellation at death.⁴¹ The privately issued annuity is purely life contingent: payments are made until death and there is no obligation to pay anything beyond death. In this circumstance, it is inappropriate to treat the termination of a privately issued annuity as involving a transfer of an obligation by the estate of decedent within the meaning of sections 691(a)(2) and 691(a)(5). We recommend that the Service

³⁸ See Reg. § 1.1275-1(j)(2)(i). A typical privately issued annuity is an immediate life annuity with no commutation right, or minimum or maximum payout provisions, which would not be treated as a debt instrument under section 1275(a)(1)(B)(i).

³⁹ One could try to limit the category of annuities treated as debt to those that are issued for property, but the distinction between cash and property is exceedingly arbitrary in this context. Indeed, the preamble to the Proposed Regulations specifically states that transferors should be taxed the same regardless of whether they exchange property for an annuity or sell that property and use the cash proceeds to buy the annuity. 71 FED. REG. at 61,443. Beyond eliminating section 72, treating commercial annuities issued for cash as debt would effect a sea change in the taxation of life insurers, potentially impacting not only qualification status under section 816(a), but also reserving under section 807(c).

⁴⁰ See Rev. Rul. 86-72, 1986-1 C.B. 253; *Estate of Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993) (accord).

⁴¹ According to GCM 39503, a self-cancelling installment note that provides for installment payments over a term greater than the recipient's life expectancy should be treated as a privately issued annuity. Thus, this type of private annuity does provide for a maximum selling price. However, our recommendation in this part II.B.h. is not intended to extend to these self-cancelling installment notes.

confirm this point in the preamble to final regulations, addressing the treatment of privately issued annuities as installment sales.

g. New Proposed Regulation Project under Section 453

The foregoing comments are not an exhaustive cataloging of the issues or questions relating to the installment sale rules. If the Treasury and the Service should decide to treat all privately issued annuity contracts as installment sales, as we recommend, we believe it would be appropriate to do so through a new proposed regulation project under sections 453, *et seq.* At that time, we would anticipate following up this letter with additional specific comments and more technical suggestions on the applicability of the installment sale rules to privately issued annuity transactions, including, as necessary, suggested regulatory language.

C. Charity-Issued Annuities In Bargain Sales

The regulations under section 1011 create a special rule for annuities issued by charities in bargain sale situations.⁴² The regulations provide, in general terms, that gain is deferred and recognized ratably over the life expectancy of the taxpayer-transferor. This treatment, however, is only available if the annuity contract is nonassignable (except to the issuing charity). Retention of this gain deferral regime for charity-issued annuities is inconsistent with the reasons advanced by the Treasury and the Service for requiring Full Recognition for non-charity-issued private annuities: “transferors should be taxed in a consistent manner regardless of whether they exchange property for an annuity or sell that property and use the proceeds to purchase an annuity.”⁴³ Accordingly, unless there is a tax policy rationale specific to charities that would justify this special rule (in which case, we think it is incumbent on the Treasury and the Service to plainly articulate this policy), then we recommend that this exclusion of charity-issued annuity contracts from the ambit of the Proposed Regulations be eliminated in the final regulations.⁴⁴

D. Effective Date

The Proposed Regulations represent a reversal of the longstanding rules for taxing the transferor in a privately issued annuity transaction—rules which were created by the Service in Rev. Rul. 69-74. The issuance of the Proposed Regulations came without any formal warning or indication that the issue was being considered; the Priority Guidance Plan provided no clear “heads up” regarding such new guidance. In

⁴² Reg. § 1.1011-2(c).

⁴³ 71 FED. REG. at 61,443.

⁴⁴ The unjustified retention of this rule for charity-issued annuities only serves to undermine the legitimacy of the general rule that the Proposed Regulations would impose on non-charity-issued annuities. *Cf. 212 Corp.*, *supra* note 28, at 814 (Simpson, J., dissenting).

these circumstances, where taxpayers have been conducting their affairs in reliance on tax rules created by the courts and the Service, we think some transition relief is appropriate for taxpayers caught in the middle of transactions that had not closed by October 18, 2006, the day the Proposed Regulations were released, without prior notice, to the public. The Treasury and the Service recognize this point, since the Proposed Regulations do extend the effective date to April 18, 2007, for transactions that meet three conditions. These latter transactions are granted the benefit of a delayed effective date under the reasoning that they “present the least opportunity for abuse.”

We acknowledge, as noted above, that there are privately issued annuity transactions that “cross the line” and can be fairly characterized as abusive. For these cases, a delayed effective date may be inappropriate, although the Government, of course, does retain the ability to challenge abusive transactions under its formidable arsenal of tax shelter weapons, regardless of when the Proposed Regulations become effective. We also agree with the Department and the Service’s own statement that clearly there are “valid” privately issued annuity transactions, for which an immediate effective date is unfair. The question, then, is whether the three conditions in the Proposed Regulations properly and accurately sketch out the line between the abusive and the nonabusive cases when the Government has other “tools” to attack the abusive case. We believe they do not.

Specifically, we do not think that the condition that the annuity issuer be an individual can be defended as validly distinguishing between abusive and non-abusive cases. There is no inherent reason why an annuity issued by a trust cannot be a valid privately issued annuity transaction, particularly if the other two conditions are met. Moreover, in Rev. Rul. 62-136, the Service ruled that private annuity treatment does not extend to “corporations, trusts, funds or foundations” that issue annuity contracts “from time to time,” meaning that so long as a corporation, trust, fund, or foundation issuer was not in the business of issuing annuity contracts “from time to time,” the private annuity rules would apply. Taxpayers have long relied Rev. Rul. 62-136 for the proposition that private annuity issuers are not limited to individuals. We think that conditioning favorable transition relief on the identity of the issuer as an individual is unfair in this context. Given that Rev. Rul. 62-136 specifically blesses entity-issued private annuities, provided the entity does not issue annuities from time to time, it is inappropriate for the Service to now suggest that the fact that a private annuity is issued by an entity is presumptively abusive.

Similarly, we do not think the condition that the transferred property be retained for at least two years can be defended as validly distinguishing between abusive and non-abusive cases. This rule apparently is inspired by the two-year rule for related party installment sales in section 453(e)(2), and is aimed at one of the types of privately issued annuity transactions that are perceived as abusive: interposition of a trust between a seller and a third party who has already negotiated to purchase the property from the seller. These transactions are susceptible to challenge under various grounds, such as assignment of income principles, step transaction, sham transaction, *etc.* A two-year requirement is merely a prophylactic device. As such, clearly it will have the effect of

denying transitional relief to some transactions that are legitimate. We would recommend replacing this condition with one more carefully tailored to the underlying abuse concerns.

In light of the foregoing comments, we would recommend that the regulations, as finalized, be effective for exchanges of property for an annuity contract that occur after April 18, 2007, except that the regulations are effective for any exchange that occurs after October 18, 2006, if (A) the obligations under the annuity contract are secured, directly or indirectly, or (B) the exchange is part of a plan or arrangement, in effect at the time of the exchange, for the subsequent sale or other disposition of the property by the transferee.

E. Commercial Annuities

By their terms, the Proposed Regulations would apply to property exchanged for either a commercial or a privately issued annuity. As noted above, however, the Proposed Regulations are unlikely to have a material impact on U.S. life insurance companies, since they generally do not issue annuity contracts for property. A rare exception to this might be a “failed” section 1035 exchange, where presumably the insurance company would be treated as issuing an annuity in exchange for property (*i.e.*, an existing insurance contract) in a taxable transaction. A second, equally rare situation would be a transfer of securities or real estate to a separate account in exchange for a variable annuity contract based thereon. Such a transaction, however, normally would raise significant “investor control” concerns.⁴⁵

Since commercial annuity-for-property exchanges are unlikely to occur except in rare circumstances, we have not undertaken to review whether the Proposed Regulations should be modified to accommodate commercial annuity transactions, with one exception. The one exception we would note is the seemingly blanket requirement of valuation under section 7520. Commercial annuities are not valued under section 7520. We would therefore suggest revising Proposed Regulation section 1.1001-1(j)(1) to read as follows: “The amount realized attributable to the annuity contract is the fair market value of the annuity contract at the time of the exchange, *which shall be determined under section 7520 to the extent that section is otherwise applicable.*”

⁴⁵ See, *e.g.*, Rev. Rul. 77-85, 1977-1 C.B. 12

APPENDIX

EXAMPLE 1: Installment Method of Accounting Privately Issued Annuities

Facts: On January 1, 2007, individual A transfers Blackacre, a long term capital asset, to individual B in exchange for B's promise to pay A \$10,000 cash down and an annual payment of \$10,000 on January 1 of each succeeding year for as long as A lives.

A's adjusted basis in Blackacre is \$20,000.

A's life expectancy is 15 years (as derived from the tables in Treas. Reg. § 1.72-9).

The fair market value of the annuity is \$95,000.

Step 1: The fair market value of the \$10,000 per year annuity promise is calculated under section 7520. In this case, FMV is assumed to be \$95,000.

Step 2: A realizes sale gain of \$75,000 (\$95,000 FMV minus A's \$20,000 adjusted basis).

Step 3: Compute "gross profit ratio" by dividing the gross profit (\$75,000) by the total contract price (\$95,000), which equals 78.95%

Step 4: Construct a payment schedule by allocating the total contract price (\$95,000) over A's life expectancy (15 years).

Year	Payment (\$95,000/15)
1	\$6,333.33
2	\$6,333.33
3	\$6,333.33
4	\$6,333.33
5	\$6,333.33
6	\$6,333.33
7	\$6,333.33
8	\$6,333.33
9	\$6,333.33
10	\$6,333.33
11	\$6,333.33
12	\$6,333.33
13	\$6,333.33
14	\$6,333.33
15	\$6,333.33

Step 5: Multiply each payment on the above schedule by the profit ratio (78.95%) to compute the taxable gain amount with respect to each annual annuity payment.

Year	Taxable Gain
1	\$5,000.00
2	\$5,000.00
3	\$5,000.00
4	\$5,000.00
5	\$5,000.00
6	\$5,000.00
7	\$5,000.00
8	\$5,000.00
9	\$5,000.00
10	\$5,000.00
11	\$5,000.00
12	\$5,000.00
13	\$5,000.00
14	\$5,000.00
15	\$5,000.00

Summary -- Of each annual annuity payment of \$10,000, individual A must recognize \$5,000 as long term capital gain

Step 6: Compute the exclusion ratio under section 72 (fair market value (\$95,000) divided by expected return (\$150,000) = 63.33%). Then compute the portion of each annuity payment taxable under section 72:

Year	Annuity Payment	Excludable under sec. 72	Taxable under sec. 72
1	\$10,000.00	\$6,333.33	\$3,666.67
2	\$10,000.00	\$6,333.33	\$3,666.67
3	\$10,000.00	\$6,333.33	\$3,666.67
4	\$10,000.00	\$6,333.33	\$3,666.67
5	\$10,000.00	\$6,333.33	\$3,666.67
6	\$10,000.00	\$6,333.33	\$3,666.67
7	\$10,000.00	\$6,333.33	\$3,666.67
8	\$10,000.00	\$6,333.33	\$3,666.67
9	\$10,000.00	\$6,333.33	\$3,666.67
10	\$10,000.00	\$6,333.33	\$3,666.67
11	\$10,000.00	\$6,333.33	\$3,666.67
12	\$10,000.00	\$6,333.33	\$3,666.67
13	\$10,000.00	\$6,333.33	\$3,666.67
14	\$10,000.00	\$6,333.33	\$3,666.67
15	\$10,000.00	\$6,333.33	\$3,666.67

SUMMARY:

Each annual annuity payment of \$10,000 consists of (i) \$5,000 of sale gain taxable pursuant to section 1001(b) and the installment method of accounting; (ii) \$3,667.67 of ordinary income taxable under section 72 (in the nature of discount income), and (iii) a nontaxable return of basis equal to the remaining \$1,333.33 (which can be independently calculated by dividing A's adjusted basis in Blackacre by A's life expectancy of 15 years).

EXAMPLE 2: Installment Method of Accounting
Privately Issued Annuities: *the short lived annuitant*

Facts: The same as in Example 1, except that individual A dies on January 2, 2016 (*i.e.*, A only lives 10 years after the sale).

Total gross income:	\$100,000	[\$10,000 x 10 years]
Total net income:	\$80,000	[\$100,000 - \$20,000 basis]
Capital gains reported:	\$50,000.00	[\$5,000 x 10 years]
§ 72 income reported:	\$36,667.00	[\$3,666.67 x 10 years]
Total income reported:	\$86,667.00	
Income overreported:	\$6,667.00	[\$80,000 actual net income - \$86,667.00 income reported]

- 1.** Under section 72(b)(3), A is allowed an ordinary loss deduction for his unrecovered investment in the contract. This amount equals A's original investment in the contract (\$95,000) minus the amount of A's investment in contract recovered to date (\$63,333 (*i.e.*, 10 years x \$6,333)), which equals \$31,667 (\$95,000 - \$63,333).
- 2.** The \$31,667 amount, however, reflects \$25,000 of unrecognized sale gain referred under the installment sale rules. The investment in the contract should be reduced by this deferred gain amount. The unrecovered investment in the contract, therefore, is reduced to \$6,667 (\$31,667 - \$25,000).
- 3.** The ordinary loss deduction that A is entitled to under section 72(b)(3), therefore, equals \$6,667. As a result, the total net amount of § 72 income reported by A is \$30,000 (\$36,667 amount previously reported - \$6,667 deduction allowed under § 72(b)(3)).
- 4.** Summary: The total net income reported by A with respect to the transaction is \$80,000 (\$50,000 capital gains + \$36,667 § 72 income - \$6,667 deduction under § 72(b)(3)).