

# PRIVATE ANNUITIES

SHELDON V. EKMAN\*

In recent years considerable interest has been manifested by estate planners in various forms of annuity contracts, because of the special tax treatment afforded annuities by the Internal Revenue Code. An annuity has traditionally been defined as "a yearly sum stipulated to be paid to another in fee, or for life, or years, and chargeable only on the person of the grantor,"<sup>1</sup> yet for tax purposes the statutory definition did not include payments for a fixed period of years until the 1954 Code.

It is desirable for present purposes to distinguish between commercial and non-commercial or private annuities. The former term refers to an annuity contract issued for cash by an insurance or other company regularly engaged in the business of issuing such contracts, the terms or cost of which are fixed according to generally accepted actuarial or mortality tables. The term "non-commercial" or "private" annuity, as used herein, may be defined generally as including all other arrangements pursuant to which cash or other property is transferred in exchange for the undertaking of the transferee to make payments for a term certain or for the life of the transferor.

The foregoing two types of annuity are of course not susceptible of a sharply defined line of separation, and certain kinds of annuities may indeed share some of the characteristics of both commercial and non-commercial types. For example, contributory pensions or employees' annuities paid by an employer may or may not be funded by an insurance company, and may or may not be computed in accordance with actuarial tables or tables of mortality.

Under the provisions of the Internal Revenue Code of 1939<sup>2</sup> an annuitant was taxed each year upon so much of the payment received as equalled 3% of the consideration he had paid for the annuity; the remainder of each annual payment was free of tax until such time as the excluded amounts equalled his cost. Once cost was recouped, the entire amount received was thereafter subject to tax. Under this rule, it often occurred that annuitants died before they had recovered their costs tax-free.

In order to provide a more equitable method of taxing annuities, Congress made substantial changes in the statute when it enacted

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\* Member, New Hampshire and New York Bars; Lecturer, New York University Annual Institute on Federal Taxation since 1950; Dickinson College Institute on Federal Taxation; Rutgers University Law School Tax Institute.

<sup>1</sup> Coke, Littleton, \*144; Kent, Commentaries \*460.

<sup>2</sup> Int. Rev. Code of 1939, § 22(b)(2).

section 72 of the Internal Revenue Code of 1954. As a result, under present law, the annuitant is entitled to receive tax-free a portion of each annual payment equal to the ratio computed by dividing his cost by his life expectancy at the annuity starting date. The annuitant is allowed to exclude the amount computed by the use of this exclusion ratio from taxable income annually, even if he outlives his life expectancy. The remainder of each annual payment is taxed as ordinary income. The provisions of section 72 appear more likely to allow a greater proportion of annuitants to recover their full costs tax-free than did the old 3% rule. Furthermore, since under the new provision the taxable amount remains constant, the former sharp increase in taxable income, once cost has been recouped, is eliminated.

With respect to commercial annuities purchased from insurance companies or private annuities purchased for cash, the statutory rules are clear and present few, if any, problems. But the usual non-commercial or private annuity transaction contemplates the transfer of property by the annuitant, and in arrangements of this type vexing problems often inhere. One of the first problems is that of determining the cost of the annuity in order to compute the exclusion ratio. Even if it be assumed that the fair market value of the transferred property at the date of transfer determines the cost of the annuity—and such an assumption is not always safe—the determination of that value is frequently difficult, and there is no assurance that a value so arrived at will be acceptable to the Internal Revenue Service upon audit as establishing the cost of the annuity.

In spite of their complexity, private annuities have a definite utility in appropriate situations, and, if employed with proper knowledge of the problems involved, have a place in estate planning. However, it should not be forgotten that the creation of such an annuity will carry tax consequences not only for the annuitant, but also for the transferee of the property who pays the annuity. Moreover, a consciousness of estate tax problems of the annuitant is not enough, for the transaction may have income or gift tax consequences for him as well. And in some instances, the annuitant and the payor of the annuity may have divergent interests; for example, if appreciated property is transferred, the annuitant might wish to avoid tax on capital gain by treating the appreciation as a gift, whereas the payor might be better served by treating it as consideration, since he would thereby acquire an increased basis for the property.

Private annuities may take several forms: perhaps the simplest type involves the transfer of income-producing property by an elderly parent to his children in exchange for a fixed annual amount to be paid for the life of the parent. A variation of this arrangement sets

no specific annual amount but involves merely the promise of the children to support the parent for his lifetime. A more recent arrangement which has acquired considerable notice is the type of private annuity offered by a charity (often a college or university) whereby the charity undertakes to pay an annuity for the life of the transferor of property; current limitations in this area will be discussed later. Still another form which, while not ordinarily called a private annuity, comes within the term is a trust, testamentary or inter vivos, whereby the beneficiary is given the right to invade principal each year in an amount which will consume the entire corpus of the trust over the normal expectancy of the beneficiary's lifetime.

Before discussing the specific tax treatment and problems of private annuities, it is proper to observe that the creation of a private annuity gives rise to certain practical problems for the parties. For instance, if appreciated property is transferred and a gift tax is incurred, the annuitant is at once faced with the practical problem of securing the funds with which to make payment of the gift taxes. If the only source of income of the annuitant is the very property which he transfers, this poses a serious problem. One solution may be to have the transferee assume the burden of the gift tax to be paid, either by having the transferee pay the tax directly out of the income of the property or by having him make larger annual payments to the transferor.

From the viewpoint of the annuitant there is another serious practical risk involving his lack of security if the transferee sells or otherwise disposes of the income-producing property. It is of course true that the annuitant has available to him the usual legal remedies which any obligee has in the event of a breach of contract. But the tangible benefits to be derived by invoking those remedies will be of cold comfort indeed if the obligor, having transferred the property, is without other assets from which to make the annuity payments. Yet at the same time it may be difficult, as a practical matter, to impose effective restraints on alienation, and, what is even worse, any attempt to impose such restraints in order to provide a security device for the annuitant carries with it the danger that the Internal Revenue Service may regard the security device as a right of reverter which will render the value thereof includible in the annuitant's estate.

Changes in the economy may pose other potential difficulties in the use of private annuities. The yield from the property transferred may be drastically diminished through changes in the interest rate or other similar factors, and if an economic downtrend continues long enough or if a change in the particular business occurs, the income from the property may cease entirely. In this connection the trans-

feror must consider whether or not he should retain any right to compel the payor to dispose of the property or to mortgage it and to re-invest the proceeds in other property which will provide sufficient income out of which he may discharge his obligation to the annuitant. Such questions are not properly tax matters, but before any private annuity transaction is recommended, careful consideration should be given to all the practical aspects by both the annuitant and the transferee and their professional advisors.

#### INCOME TAX CONSEQUENCES

The income taxation of the annuitant in a private annuity is governed by the same rules as those applicable to a commercial annuity, *i.e.*, the annuitant is entitled to exclude from income annually the amount computed by dividing cost by his life expectancy. But the Commissioner draws a distinction between a commercial annuity and a private annuity with regard to the determination of cost. The Internal Revenue Service considers that a private annuity transaction actually consists of two steps: (1) a sale of the property, and (2) a purchase of an annuity with the sales proceeds. The adoption of the sale-purchase theory by the Commissioner is embodied in Revenue Ruling 239<sup>3</sup> and consistent therewith, the Commissioner requires that the fair market value of the property at the date of transfer, rather than the adjusted basis of the annuitant in the property, be used as the cost of the annuity.

It appears to be well settled that no gain is realized at the date of transfer<sup>4</sup> and accordingly no tax is then payable. The courts reach this result because the unsecured promise of the transferee is considered to be without ascertainable fair market value, since there is no assurance that he will be able to make the annual payments. Revenue Ruling 239, *supra*, adopts this approach, citing cases such as *Hill's Estate v. Maloney*,<sup>5</sup> which involved transfers of property to individual members of the annuitant's family. These cases are based on a rationale which is supportable on their particular facts, but there is some question as to how far they may be applicable to different facts. For example, while the naked unsecured promise of an individual is held to have no ascertainable fair market value, is this true also of the promise of a trustee? And compare the trustee of a trust whose only res is the property transferred with one whose trust owns substantial assets and has large other income out of which

<sup>3</sup> 1953-2 Cum. Bull. 53.

<sup>4</sup> *Comm'r v. Estate of Bertha F. Kann*, 174 F.2d 357 (3d Cir. 1949); *J. Darsie Lloyd*, 33 B.T.A. 903 (1936).

<sup>5</sup> 58 F. Supp. 164, 33 Am. Fed. Tax R. 479, 45-1 U.S.T.C. ¶ 9102 (D.N.J. 1944).

annuity payments may be made. It has been suggested that the promise of any promisor (whether an individual, trustee or corporation) who is not engaged in the business of writing annuities is without ascertainable fair market value, regardless of the solvency or net worth of the promisor.<sup>6</sup> But this seems to go beyond the rationale of the cases cited to support the proposition. The use of a trust has already proved dangerous for estate tax purposes,<sup>7</sup> and it is well to view the estate tax cases as a guide to potential income tax consequences. One thing is certain: if the payor is a commercial insurance company, the annuitant will be taxed when the annuity contract is received by him.<sup>8</sup> The unsettled problem is at what point between the promise of an individual transferee and that of a commercial insurance company the line of taxability begins.

### *Transfers of Appreciated Property*

The effect of the foregoing rules is that the annuitant under a private annuity is taxed only at the times and to the extent that he receives payment, and then his tax is governed by the provisions of section 72 of the Internal Revenue Code of 1954. This treatment is especially helpful to the transferor of appreciated property since the tax on his capital gain is postponed and spread. The annuitant is permitted to exclude from each payment the amount computed by dividing his life expectancy into the fair market value of the property, which is deemed to be his cost. The remainder of each annual payment is subject to tax as ordinary income. When the original cost basis of the property has been fully recouped through annual exclusions, the previously excludable portion is taxed each year as capital gain until the full amount of appreciation has been taxed; thereafter, the excludable portion resumes its tax-free character.

Consistent with the theory that no closed transaction has taken place at the date of transfer of appreciated property in exchange for an annuity, so that no gain is then realized, the courts hold that any loss incurred upon the transfer is not deductible in the year of exchange.<sup>9</sup> This result follows logically from the basic assumption that the promise of the payor is without ascertainable fair market value from which the amount of any loss can be computed. Moreover, the courts reason that the annuitant has not entered into the

<sup>6</sup> See 10 Journal of Taxation 324 (June, 1959). This is based on cases such as those cited *supra* note 4.

<sup>7</sup> *Updike v. Comm'r*, 88 F.2d 807, 19 Am. Fed. Tax R. 194, 37-1 U.S.T.C. ¶ 9170 (8th Cir. 1937).

<sup>8</sup> *Morse v. Comm'r*, 202 F.2d 69, 43 Am. Fed. Tax R. 257, 53-1 U.S.T.C. ¶ 9202 (2d Cir. 1953).

<sup>9</sup> *Evans v. Rothensies*, 114 F.2d 958, 40-2 U.S.T.C. ¶ 9681 (3d Cir. 1940).

transaction for profit. This latter conclusion does not bear close scrutiny, for the transferee has been allowed to deduct as losses the payments made by him in excess of the value of the property transferred, upon the specific rationale that the transaction was one entered into for profit by the transferee.<sup>10</sup> But the annuitant is not allowed any loss deduction, either at the date of transfer, or at death in the event that he fails to live long enough to recoup his cost of the annuity,<sup>11</sup> because the courts insist that he has not entered into a profit-motivated transaction. Yet there is apparent agreement that if the property is sold and thereafter the annuitant fails to live long enough to receive payments equal to the value of the property, the transferee-payor is in receipt of taxable income.<sup>12</sup>

### *Income Tax Problems of the Transferee*

Revenue Ruling 55-119 prescribes rules for the treatment of basis problems by the transferee and for the determination of gain or loss. These questions are complex and there are still areas in which the applicable rules are not easily determinable, in spite of the Commissioner's comprehensive ruling. In at least one important aspect the ruling is in conflict with the *Sheridan* case; yet the ruling does not mention that case, even though the Commissioner's acquiescence in the decision has been published.

The Commissioner adopts the premise that where the transferee is not in the business of writing annuities, there can be no closed transaction until the death of the annuitant. Accordingly, there can be no determination of the cost of the property to the transferee until he is released from his obligation to make payments by the death of the annuitant. The total amount of payments actually made during the life of the annuitant is then fixed as the cost of the property.

It is at once obvious that this rule will be inadequate where business property is transferred, since the transferee must know his basis immediately in order to compute depreciation. The ruling provides that basis in such case shall be the actuarial value of the payments which the transferee is obligated to make over the annuitant's life expectancy, and permits depreciation of such basis until the transferee's actual annuity payments have equalled the amount of basis so computed. If payments continue thereafter, the additional annuity payments may be added to basis for depreciation purposes. This latter provision overlooks the Tax Court's ruling in *Sheridan*,

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<sup>10</sup> Donald H. Sheridan, 18 T.C. 381 (1952).

<sup>11</sup> Industrial Trust Co. v. Broderick, 94 F.2d 927, 20 Am. Fed. Tax R. 1021, 38-1 U.S.T.C. ¶ 9136 (1st Cir.), cert. denied, 304 U.S. 572 (1938).

<sup>12</sup> Donald H. Sheridan, *supra* note 10; Rev. Rul. 55-119, 1955-1 Cum. Bull. 352.

which allows the deduction of annuity payments in excess of basis as losses in the year paid. Upon the death of the annuitant, the ruling provides that the total of actual payments shall be the basis for subsequent depreciation.

Under the Commissioner's ruling it is possible to have three different cost bases for depreciation, and thus three different amounts of annual deduction for depreciation on the same property. The *Sheridan* rule, on the other hand, by allowing payments in excess of basis to be deducted as losses in the years paid, maintains the amount of depreciation deduction at a constant figure.

In the event of sale or disposition of the property after the death of the annuitant, the cost basis is the total of annuity payments made by the transferee. If the disposition takes place during the annuitant's life and a gain results, the basis is the sum of actual payments made to the date of disposition, plus the actuarial value of payments to be made, determined according to the annuitant's life expectancy. If a loss is incurred, however, the basis to be used is merely the amount of payments made to the date of sale. No gain or loss will be recognized if the property is disposed of for a price which is less than the basis for gain but more than the basis for loss.

If, after the property has been sold or disposed of, the transferee continues to make annuity payments to the point where the total payments made both before and after the sale exceed the basis used in determining gain or loss on the disposition, he may deduct the excess as a loss in the year or years of payment. As a result, in cases where loss was recognized on the sale, all subsequent annuity installments will be deductible as losses. If neither gain nor loss was recognized upon the sale, such payments will be deductible only after total actual payments, less depreciation allowed or allowable for the period the transferee held the property, exceed the selling price.

If the property is sold at a gain, and the transferee pays a tax at the date of sale on the gain thus recognized, the transaction is still not regarded as closed. Thus, if it appears at the death of the annuitant that the total amount of annuity payments made by the transferee-seller is less than the unadjusted basis used in computing gain on the sale, the excess of basis over payments made is taxable as income to the transferee in the year of the annuitant's death. If the sale gave rise to a loss, there will of course be no gain upon the death of the annuitant, but if the sale resulted in the recognition of neither gain nor loss, and the total payments less depreciation are less than the sales price, taxable income to the transferee in the year the annuitant dies will result.

## GIFT TAX CONSEQUENCES

Ordinarily, the exchange of property for a private annuity will not give rise to a gift tax, since the usual transaction involves an exchange of equal values. But in the case where the property transferred is worth more than the value of the annuity, there is lack of adequate consideration and gift tax problems arise. The first problem is that of valuing the annuity received. While in most annuity situations the fair market value of the property at date of transfer is deemed to be the cost of the annuity, the rule with respect to gifts is different. It is necessary to determine the actuarial value of the annuity, and this may be done either by reference to the cost of a comparable annuity from a commercial insurance company, or by reference to the expectancy tables contained in the Commissioner's estate and gift tax regulations.<sup>13</sup> The courts seem to prefer the use of the Commissioner's mortality tables.<sup>14</sup> Once the actuarial value of the annuity is thus determined, any excess value of the property transferred is taxable as a gift.

An exchange of unequal values will not always be held to result in gift tax consequences. In *Beattie v. Comm'r*<sup>15</sup> the donor transferred to a college property valued at much more than the actuarial value of the annuity the college agreed to pay him. Nonetheless, the court found that the entire value of the property was the cost of the annuity and that no part of the property was a gift. Under the then applicable law, the effect of the court's holding was that 3% of the entire value of the property was taxable to the annuitant each year. Had a specific amount been denominated as a gift to the college, it may well be that the result in the case would have been different. And a similar transfer to a member of the annuitant's family might, under present law, lead to a different conclusion. The case is of interest, however, as an indication that gift tax need not always be incurred by an exchange of unequal considerations.<sup>16</sup>

Conversely, an apparently equal exchange may not always avoid a gift tax. Thus, although the actuarial value of an annuity may be equal to the value of the property exchanged, the physical condition

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<sup>13</sup> These tables are based on the United States Life Tables and Actuarial Tables, and may be found in the annuity regulations, Treas. Reg. § 1.72-9 (1957), and the gift-tax regulations, Treas. Reg. § 25.2512-5(f) (1958).

<sup>14</sup> Koert Bartman Estate, 10 T.C. 1073 (1948).

<sup>15</sup> 159 F.2d 788, 35 Am. Fed. Tax R. 843, 47-1 U.S.T.C. ¶ 9153 (6th Cir. 1947).

<sup>16</sup> But *cf.* Anna L. Raymond, 40 B.T.A. 244, *aff'd*, 114 F.2d 140, 25 Am. Fed. Tax R. 583, 40-2 U.S.T.C. ¶ 9540 (7th Cir.), *cert. denied*, 311 U.S. 710 (1940) holding that cost is limited to what an insurance company would charge and that the excess is a taxable gift. See also Estate of Sarah A. Bergan, 1 T.C. 543 (1943).

of the annuitant may be such that it is obvious that payments will not be made over the normal period of life expectancy.<sup>17</sup> Expectancy tables are evidentiary only, and must yield to the realities of a particular case.

The transfer of property in exchange for the payment of an annuity to the annuitant for life and thereafter to another for life, will of course constitute a taxable gift with regard to so much of the value of the property as constitutes the measure of the survivor's rights.<sup>18</sup> This is a typical situation in which the marital deduction may operate advantageously.

In situations where a gift is considered to have been made, it should be remembered that the transferee's basis will be reduced by the amount of the gift.<sup>19</sup>

#### ESTATE TAX CONSEQUENCES

The estate tax, like the gift tax, is applicable to private annuities only in the case of exchange of unequal values where the transferor retains an interest in the property transferred sufficient to bring it into his gross estate. Such a result may be brought about in several ways.

One common desire of most annuitants is to retain some sort of security provision in order to safeguard the annuity, but any such device is likely to cause the transaction to be viewed as the creation of a trust with the reservation of a life estate, and consequently to result at death in the includibility of the life interest in taxable gross estate.<sup>20</sup> Similarly, the use of the income from the property as the measure of the annuity will be regarded as the reservation of a life interest in the property; for this reason a fixed annual payment should be specified, regardless of the actual income from the property. A situation in which property with a value in excess of the value of the annuity to be paid is transferred will be vulnerable to attack as a transfer intended to take effect at death. If the facts do not support the theory of a reserved life interest, the transfer may still be includible as having been made in contemplation of death. This is particularly true of transfers between members of a family, as in the *Updike* case.<sup>21</sup>

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<sup>17</sup> Estate of Huntington National Bank of Columbus, 13 T.C. 760 (1949); Estate of Nellie H. Jennings, 10 T.C. 323 (1948); Estate of John H. Denbigh, 7 T.C. 387 (1946).

<sup>18</sup> Treas. Reg. § 1.1015-4 (1957).

<sup>19</sup> Rev. Rul. 55-388, 1955-1 Cum. Bull. 233.

<sup>20</sup> *Tips v. Bass*, 21 F.2d 460 (W.D. Tex. 1927); *Cornelia B. Schwartz Estate*, 9 T.C. 229 (1947).

<sup>21</sup> *Supra* note 7.

The Internal Revenue Service will be alert to the possibilities of asserting gift and/or estate taxes in cases where an elderly transferor exchanges valuable property for an annuity, the annual amount of which is equal to or less than the income from the property, and the actuarial value of which is less than the value of the property conveyed. Such a transfer may be attacked by the Commissioner on one or more theories, *e.g.*, as a taxable gift, as a device for income tax avoidance through the provisions of section 72 of the Internal Revenue Code of 1954, or as a gift in contemplation of death and thus an estate tax avoidance scheme. The possibility of such a challenge is only intensified when the parties to the transaction are members of a family.

In order to avoid problems in this area, it is common to divide the transfer into two parts, so that the annuity transaction reflects an exchange of equal values, and the excess value is clearly treated as a separate gift. In this manner it is possible to minimize the dangers of a claim that the annuitant had retained the income from the property for his lifetime. Any gift tax which may be incurred upon the separate gift will in all probability be far less than the potential income and estate tax liabilities which are thereby prevented.

#### TRANSFERS TO CHARITY IN EXCHANGE FOR AN ANNUITY

By far the most publicized form of private annuity in recent years has been the type of plan whereby annuities are issued by charitable organizations, such as colleges and universities. Many of these institutions have published descriptions of their plans and have actively solicited the exchange of property for annuities. Normally the cost of the private annuity issued by institutions is computed through the use of an actuarial table. The desirability of the college-sponsored annuity is considerably increased by the fact that the college invests the proceeds of the donor's property in tax-exempt securities and in this manner offers the donor not only an annuity income, but one which is tax-free during his lifetime. In form, the transaction involves the creation of a trust, which, pursuant to sections 652(b) and 662(b) of the Internal Revenue Code of 1954, permits the treatment of the amounts received as tax-exempt if they would have been tax-exempt in the hands of the trust. Moreover, the owner-annuitant who transfers property with a value in excess of the cost of the annuity may receive a deduction for a charitable contribution in the amount of the excess value;<sup>22</sup> needless to say the deduction may not exceed the present value of the remainder interest

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<sup>22</sup> *Supra* note 16.

which would ultimately vest in the charity after the death of the donor. There is some question as to whether the charitable deduction is limited to 20% or 30% of adjusted gross income because of the fact that the property or the proceeds are held in trust form and the contribution is therefore not made directly to a church, hospital or school.<sup>23</sup> No charitable deduction for the portion of the property transferred which represents the cost of the annuity will be allowed.<sup>24</sup>

The annuities offered by colleges, churches and other eleemosynary institutions have enjoyed considerable popularity because they offer all of the desirable features of private annuities, and more. Thus, they provide a method whereby the donor is assured not only of an annuity, but of one consisting of income totally exempt from income tax. In addition, the charitable annuity plans provide a vehicle through which a donor may reap the intangible rewards derived from philanthropy and the concomitant perpetuation of the donor's name thereby.

The charitable institutions engaged in annuity plans have, however, suffered a serious blow by the Commissioner's promulgation on December 2, 1960 of Revenue Ruling 60-370,<sup>25</sup> which has removed perhaps the most attractive feature proffered to potential donors. This ruling provides in substance that where a taxpayer transfers appreciated securities or other property to a tax-exempt organization, as trustee, and the charity is under an express or implied obligation to sell the property and invest the proceeds in tax-exempt securities or to exchange the property for tax-exempt securities and thereafter to pay the income to the transferor for life with remainder to the charity, the transferor will be subject to tax on the capital gain arising from the sale or exchange of the appreciated property by the trustee. The rationale of this ruling is based on the sale-purchase theory of an annuity. The ruling holds that in substance the transferor did not convey the appreciated property to the trustee, but rather gave to the trustee the proceeds of the sale

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<sup>23</sup> The provisions of Treas. Reg. § 1.170-2(b) (1958), and of Rev. Rul. 57-562, 1957-2 Cum. Bull. 159, would appear to limit the deduction to 20%, consistent with the use of the trust device (which is necessary in order for the income to retain its tax-free character in the hands of the donor under §§ 652[b] and 662[b]). However, in a Special Ruling letter to Pomona College, dated February 11, 1959, the Internal Revenue Service has sanctioned the use of a 30% limitation where the property is given directly to the donee to hold in trust, the income to be paid to the donor and the remainder to go to the donee. This result was foreshadowed by Rev. Rul. 57-507, 1957-2 Cum. Bull. 511, which is difficult to reconcile with Rev. Rul. 57-562, 1957-2 Cum. Bull. 159.

<sup>24</sup> Cf. Rev. Rul. 55-388, *supra* note 19.

<sup>25</sup> 1960 Int. Rev. Bull. No. 49, at 15.

or exchange of the property which the trustee was required to consummate. If the Commissioner's basic assumption is accepted, the capital gains tax must inevitably result.

The ruling goes beyond the situation where the charitable trustee is under express obligation to sell or exchange the appreciated property. It provides that statements in advertisements or brochures issued by a charitable or educational organization to the effect that the organization will sell or exchange appreciated property for tax-exempt securities will give rise by implication to an obligation to sell or exchange and will again lead to the imposition of capital gains tax on the transferor. The Internal Revenue Service recognizes that it may be necessary to go beyond the trust instrument in order to determine whether there is an obligation, express or implied, on the trustee to sell or exchange property and to invest in tax-exempt securities. Accordingly, no advance rulings will be issued as to whether such an obligation exists.

The Commissioner has provided that Revenue Ruling 60-370 will be applied only to transfers of property after December 2, 1960, so that apparently no attempt to impose the capital gains tax on institutional annuity transactions entered into prior to that date will be made. The ruling preserves the tax-exempt character of the income from the trust in the hands of the annuitant-donor, but it seems safe to predict that colleges and similar institutions will find fewer potential donors than heretofore.

#### TRANSFERS OF SECTION 306 STOCK

The contribution by a controlling stockholder in a closely held corporation of preferred or other non-voting stock to an exempt organization has long been recognized as an acceptable method of disposing of stock advantageously. If the exempt organization to which the stock is contributed is a foundation created by the donor, it is even possible to make contributions of voting stock without endangering the controlling interest of the donor. The benefits of the charitable deduction are of course substantial to a taxpayer in a high bracket, and no capital gains tax is payable upon any appreciation. Moreover, the contribution route avoids the difficulties of attempting to sell such closely held stock to outsiders at a price which fairly reflects its true value.

When the Internal Revenue Service ruled<sup>26</sup> that a contribution of preferred stock which is within the scope of section 306 of the Internal Revenue Code of 1954 would not constitute a "disposition" within the meaning of that section, the use of the charitable contribu-

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<sup>26</sup> Rev. Rul. 57-328, 1957-2 Cum. Bull. 229.

tion offered a means of reducing the estates of holders of section 306 stock without the considerable penalties which that section imposes. The Internal Revenue Service further ruled that a subsequent sale of the section 306 stock by the charity will not result in the realization of income to the donor, provided that the sale by the charity was not by prearrangement. Thus, the donor receives the benefits of a charitable contribution deduction, and is able to dispose of his section 306 stock without the realization of ordinary income which a sale or disposition by him of the stock would otherwise incur.

Under the rationale of this ruling, it would appear that if section 306 stock were contributed to a charity in exchange for an annuity, the transaction ought to be treated in the same manner as if any other stock were transferred. However, the recent issuance of Revenue Ruling 60-370, *supra*, would appear to make probable the imposition of at least a capital gains tax in the event appreciated property was transferred in exchange for a tax-exempt annuity from the charity. It is arguable, however, that no gain should be realized if the charity does not assume an obligation, either express or implied, to sell or exchange the section 306 stock transferred.

The Subchapter "C" Advisory Group to the Mills Committee has recommended that the Commissioner's ruling regarding section 306 stock be modified so that the charitable contribution deduction be reduced by the amount which would have been taxable to the donor as ordinary income if he had sold the stock instead of contributing it to charity. No action has yet been taken by Congress upon this proposal, but the House of Delegates of the American Bar Association has expressed its vigorous opposition, contending that gifts of section 306 stock should be treated no differently from charitable gifts of any other appreciated property. The advisory group's recommendation represents an extension of the sale-purchase theory which may well find its way into future legislation.

#### CONCLUSION

The rules with regard to private annuities are still in the process of development by the courts, and the final resolution of sometimes conflicting theories has not yet been achieved. Moreover, there is every reason to believe that further legislation in this field will be forthcoming. Finally, there are practical problems which confront both the annuitant and the transferee, aside from the tax questions presented. For these reasons, caution is indicated and the use of innovations not judicially sanctioned is inadvisable. Annuities often continue for lengthy periods of time, and the careful tax advisor must assume the role of prophet in deciding whether legislative revision or judicial fiat will overtake the mortality tables in any particular case.