NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED REGULATIONS REGARDING EXCHANGES OF PROPERTY FOR ANNUITIES

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Introduction

This report comments on the proposed regulations under Treasury Regulations Sections 1.72-6(e) and 1.1001-1(j) that were issued on October 17, 2006 (the "Proposed Regulations") with respect to the U.S. federal income tax treatment of the exchange of property for an annuity.[2]

As discussed more fully below, we believe that a taxpayer should generally be eligible to report any gain that it recognizes upon a sale of property for an annuity under the installment method of accounting that is set forth under Section 453 of the Internal Revenue Code (the "Code") and the regulations thereunder. If a taxpayer elects out of, or is otherwise prohibiting from using, the installment method of accounting under Section 453, then we believe that the taxpayer should be treated in the manner set forth in the Proposed Regulations under which the taxpayer would recognize gain or loss in respect of the sale based on the fair market value of the annuity at the time of the sale.

This report is divided into three parts. The first part contains a general summary of the tax accounting rules governing annuities, the historical tax treatment of

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[1] This report was drafted by Jeffrey D. Hochberg. Helpful comments were received from Kimberly S. Blanchard, Andrew H. Braiterman, Patrick C. Gallagher, Martin D. Ginsburg, Elizabeth T. Kessenides, Carlyn S. McCaffrey, Erika W. Nijenhuis, Elliot Pisem, Michael L. Schler and Andrew Walker.

[2] The exchange of property for an annuity also has estate and gift tax consequences that are not addressed by the Proposed Regulations and are not addressed by this report.

annuities that are issued in exchange for property and the tax treatment of contingent payment installment sales. Part II contains a summary of the Proposed Regulations and the preamble to the Proposed Regulations. Part III contains our recommendations regarding the appropriate U.S. federal income tax treatment of a taxpayer that exchanges property for an annuity.

I. Tax Treatment of Annuities and Contingent Installment Sales

The following section contains a general summary of the tax treatment of annuities (including the historical tax treatment of annuities that are issued in exchange for property) and the tax treatment of contingent payment installment sales. A general understanding of these rules is necessary in order to understand our recommendations regarding the tax treatment of an exchange of property for an annuity.

A. Tax Accounting for Annuities

Section 72 of the Code provides that amounts that are received under an annuity contract are included in income for tax purposes based on the "exclusion ratio" for the annuity. The exclusion ratio is a fraction the numerator of which is the taxpayer's investment in the annuity contract and the denominator of which is the taxpayer's expected return over the life of the annuity. The taxpayer's expected return over the life of the annuity is based on actuarial projections that are published in regulations under Section 72 in respect of the annuitant's remaining life. The portion of each annuity payment that the taxpayer may exclude from income is equal to the product of the payment and the exclusion ratio, and the remainder of each payment is includible as income.

The taxpayer is required to include all annuity payments in ordinary income once the amount of the annuity payments that have been excluded from the

taxpayer's income equals the amount of the taxpayer's investment in the contract. If, on the other hand, the taxpayer dies before it has recovered its investment in the annuity (i.e., the aggregate amount of distributions under the annuity that are excluded from income under the rules described above), then the taxpayer will realize an itemized deduction for the amount of the unrecovered investment.

The tax treatment of the sale of property for an annuity has been periodically addressed by the IRS and the courts. In *Lloyd* v. *Commissioner*[3], the Board of Tax Appeals held that an annuity that was received by the taxpayer in respect of a sale of property had no fair market value for tax purposes because of the uncertainty that the issuer of the annuity would be able to make the payments under the annuity. The court therefore applied the "open transaction" doctrine to the transaction and held that the taxpayer was not required to recognize gain in respect of the annuity payments until the amount received under the annuity exceeded its basis in the sold property.

The courts, however, have held that a taxpayer that sells property for a secured annuity must recognize gain or loss as of the date of the sale based on the value of the annuity at such time.[4] In addition, the IRS has ruled that a taxpayer that sells property for a commercial annuity must recognize gain or loss as of the date of the sale based on the value of the annuity at such time.[5]

The IRS has ruled that amounts that are received under an unsecured annuity that is issued for property must be divided into three components: (i) tax-free recovery of the taxpayer's basis in the sold property, (ii) gain (if any) in respect of the

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[3] 33 B.T.A.. 903 (1936), *acq.*, 1950-2 C.B. 3.

[4] *See Bell* v. *Commissioner*, 60 T.C. 469 (1973); *212 Corp.* v. *Commissioner*, 70 T.C. 788 (1978).

[5] Rev. Rul. 62-136, 1962-2 C.B. 473.

sold property and (iii) ordinary income. The taxpayer's gain in respect of the sold property is equal to the difference between its basis in the sold property and the fair market value of the annuity determined based on the tables issued under Section 7520 of the Code (which generally value the annuity based on the actuarial projected life of the annuitant). The gain is then spread ratably over the annuity payments that are scheduled to be paid over the projected remaining life of the annuitant (the "ratable basis recovery" method). The ordinary income component is determined under the general rules applicable to annuities described above and the remainder of the annuity payments are treated as a return of capital to the extent not in excess of the taxpayer's basis in the sold property.[6]

The IRS has ruled that the issuer of the annuity is entitled to a tax basis for depreciation purposes in the sold property that is equal to the fair market value of the annuity (determined based on Section 7520 as described above) notwithstanding the fact that the actual amount of cash that it will actually be required to pay in respect of the annuity is contingent on the remaining life of the annuitant. The issuer of the annuity, however, must recompute its tax basis in the sold property (i) if it sells the property, (ii) upon the death of the annuitant or (iii) when the total payments under the annuity exceed its tax basis in the property.[7] Furthermore, the issuer of the annuity is not permitted to treat any portion of the amount that it pays under the annuity as interest for tax purposes.[8]

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6 Rev. Rul. 69-74, 1969-1 C.B. 43.

7 Rev. Rul. 55-119, 1955-1 C.B. 352.

8 *See Bell* v. *Commissioner*, 76 T.C. 232 (1981) *aff'd* 668 F.2d 448 (8th Cir. 1992); *Jonathan T. Rye* v. *U.S.*, 25 Cl. Ct. 592 (1992).

The ratable basis recovery accounting method described above enables a taxpayer to defer gain upon a sale of appreciated property for an annuity in a manner that is similar to the installment sale rules under Section 453 of the Code. The taxpayer, however, is not subject to the numerous restrictions on installment sale reporting that apply to installment sales that are subject to the installment method of accounting under Section 453 of the Code. Most importantly, a taxpayer is generally not permitted to use the installment method of accounting under Section 453 if the purchaser of the property is related to the taxpayer and it sells the property within two years of the original sale.[9] We therefore understand that some taxpayers have taken the position that the ratable basis recovery accounting method described above may be applied to the sale of property to a related entity in exchange for an annuity even if the related entity sells the property shortly thereafter to an unrelated party in exchange for cash.[10]

Furthermore, the ratable basis recovery accounting method described above does not include an interest charge with respect to the deferred tax amount. By contrast, Section 453A of the Code imposes an interest charge in respect of taxpayers that hold notes that are subject to the installment method of accounting with an aggregate principal amount in excess of $5 million.

A financial instrument that is similar to an annuity is a "self canceling installment note" ("SCIN"). An SCIN is an installment note that provides for fixed

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9 IRC Section 453(e). In addition, the installment sale rules do not apply to "dealer dispositions" or sales of personal property that the taxpayer holds as inventory. Furthermore, a taxpayer that is subject to the installment method of accounting must recapture in income in the year of sale any depreciation deductions that are treated as ordinary income under Sections 1245 and 1250 of the Code.

10 In *Stokes* v. *Commissioner*, T.C. Memo 1999-204, the Tax Court disregarded the form of a similar transaction and required the seller/annuitant to recognize gain upon the sale of property to a related trust in exchange for an annuity.

payments over a fixed amount of time but that also provides that the note is cancelled upon the death of the holder of the note. The IRS has ruled that such a note is generally subject to the installment sale rules rather than the annuity rules described above as long as long as the maximum term of the note does not exceed the life expectancy of the holder of the note.[11]

B. <u>Contingent Installment Sales</u>

A taxpayer that is subject to the installment method of accounting in respect of an installment sale must include a portion of each payment that it receives under the sales agreement in income based on the ratio of the gross profit that it recognizes in respect of the sale to the total purchase price under the sales agreement (after excluding any actual or imputed interest). The application of the installment sale rules to a transaction in which the amount that will be received by the taxpayer cannot be determined by the close of the taxable year in which the sale takes place depends on whether the purchase price has a stated maximum selling price or a maximum period over which the purchase price could be received. A contingent payment sale will be treated as having a stated maximum selling price if, under the terms of the sales agreement, the maximum amount of sale proceeds that may be received by the taxpayer can be determined as of the end of the taxable year in which the sale or other disposition occurs. The stated maximum selling price is determined by assuming that all of the contingencies contemplated by the agreement are met or otherwise resolved in a manner that will maximize the selling price and accelerate payments to the earliest date or dates permitted under the agreement. If a contingent payment sale is treated as having a maximum stated

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[11] GCM 39503 (May 7, 1986).

selling price, then the maximum stated selling price is treated as the selling price for purposes of applying the general installment sale rules.[12]

When a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale occurs, but the maximum period over which payments may be received under the sales agreement is fixed, the taxpayer's basis must be allocated to the taxable years in which payment may be received under the agreement in equal annual increments.[13] If the agreement neither specifies a maximum selling price nor limits payments to a fixed period (as is the case with respect to an annuity), the taxpayer's basis (including selling expenses) is generally required to be recovered in equal annual increments over a period of 15 years commencing with the date of sale.[14]

Notwithstanding the general rules described above, a taxpayer may obtain a private letter ruling from the IRS that would permit the taxpayer to use a different basis recovery method than described above if it is able to demonstrate to the IRS that the application of the normal basis recovery rules described above would substantially and inappropriately defer the taxpayer's recovery of basis.[15] Furthermore, the IRS may require a taxpayer to use a different basis recovery method than described above if the IRS determines that the normal basis recovery rules described above would substantially and inappropriately accelerate the taxpayer's recovery of basis, unless the taxpayer is able to demonstrate either that (i) the method of basis recovery required by the IRS is not a reasonable method of basis recovery or (ii) that it is not reasonable to conclude that the

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[12] Treasury Regulations Section 15a.453-1(c)(2).

[13] Treasury Regulations Section 15a.453-1(c)(3).

[14] Treasury Regulations Section 15a.453-1(c)(4).

[15] Treasury Regulations Section 15a.453-1(c)(7)(ii).

taxpayer over time is likely to recovery basis at a rate that is twice as fast under the normally applicable basis recovery rule as the rate at which basis would be recovered under the method proposed by the IRS.[16]

If a taxpayer sells an asset for a series of contingent payments and elects not to be subject to the installment method of accounting under Section 453, then the amount realized by the taxpayer upon the sale is equal to the fair market value of the contingent payments as of the date of the sale if the fair market value of the contingent payments is readily ascertainable.[17] A taxpayer is permitted to account for the contingent payments under the "open transaction" method described above only if the fair market value of the contingent payments is not readily ascertainable. Treasury regulations, however, provide that only in "rare and extraordinary cases" will the fair market value of the contingent payments be treated as not readily ascertainable.[18]

II. Proposed Regulations

The Proposed Regulations would eliminate a taxpayer's ability to account for an annuity that is exchanged for property under the ratable basis recovery method or open transaction method described above. Rather, under the Proposed Regulations, a taxpayer must immediately recognize gain or loss upon receipt of the annuity in an amount equal to the difference between its basis in the property and the fair market value of the annuity as determined under Section 7520 of the Code. Section 7520 determines the fair market value of an annuity by applying a discount rate of 120% of the applicable mid-term federal rate to the projected payments under the annuity. The projected

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[16] Treasury Regulations Section 15a.453-1(c)(7)(iii).

[17] Treasury Regulations Section 1.1001-1(g)(3).

[18] Treasury Regulations Section 1.1001-1(g)(2)(ii).

payments under the annuity are based on the projected actuarial life of the annuitant. Thus, under the Proposed Regulations, a taxpayer that exchanges appreciated property for an annuity will be subject to tax in respect of the sale notwithstanding the fact that (i) it may not receive any cash in the year of the sale and (ii) the payments are contingent upon the remaining life of the annuitant.

The Proposed Regulations then treat the taxpayer as having invested an amount in the annuity that is equal to the amount that it realized in respect of the sale of the property. The seller is thus subject to the general rules governing annuities under Section 72 in respect of all payments that it receives under the annuity.

The Proposed Regulations, however, do not apply to an annuity that is issued by a charitable organization in connection with a bargain sale of property to the charity. Rather, the ratable basis recovery accounting method set forth under Treasury Regulations Section 1.1011-2 will continue to apply to the holder of the annuity.[19]

The preamble to the Proposed Regulations indicates that the drafters of the Proposed Regulations were particularly concerned about abusive transactions that rely on the ratable basis recovery method of accounting. More specifically, the preamble states that the "Treasury Department and the IRS have learned that some taxpayers are inappropriately avoiding or deferring gain on the exchange of highly appreciated property for the issuance of annuity contracts." The preamble further notes that "many of these transactions involve private annuity contracts issued by family members or by business entities that are owned, directly or indirectly, by the annuitants themselves or by their family members."

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[19] Treasury Regulations Section 1.1011-2(a)(4).

The preamble to the Proposed Regulations requests comments on the Proposed Regulations, including (i) whether the installment method of accounting should apply to sales of property for annuities, (ii) the tax treatment of the issuer of the annuity, (iii) whether the fair market value of the annuity should be determined in a manner other than under Section 7520 of the Code and (iv) whether annuities issued by a charitable organization should continue to be subject to the ratable basis recovery method of accounting.

III. Recommendations

A. Availability of Installment Method Election

We agree with the preamble to the Proposed Regulations that the ratable basis recovery and open transaction accounting methods described above should not apply to the exchange of property for an annuity. More specifically, we believe that the open transaction method inappropriately enables a taxpayer to recover its basis before including amounts in income in respect of the annuity and is inconsistent with the general rule that open transaction treatment should only be available in rare and extraordinary circumstances. We also think that the ratable basis recovery accounting method described above is not an appropriate method for accounting for annuities that are issued for property because it does not incorporate the anti-abuse provisions that apply to installment sales that are governed by Section 453 of the Code. In particular, we think that it is not appropriate for a taxpayer to defer gain recognition in respect of a sale of property to a related entity in exchange for an annuity if the related entity sells the property while payments are still outstanding under the annuity. The taxpayer in such a case has effectively sold the property for cash and should not be permitted to defer any gain that is recognized in respect of the sale.

Unlike the Proposed Regulations, however, we believe that a taxpayer that exchanges property for an annuity should be permitted to defer any gain that it recognizes in respect of the sale under the installment sale rules under Section 453 of the Code. Section 453 defines the term "installment sale" as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs. In the case of the sale of property for an annuity, payments will be received by the seller after the taxable year of the sale as long as the seller does not die within the year of the sale. The literal language of Section 453 thus seemingly applies to the sale of property for an annuity.[20]

Furthermore, we cannot think of any policy reason why a taxpayer that sells appreciated property in exchange for an annuity should not be permitted to use the installment method of accounting. Moreover, we understand that many taxpayers that sell appreciated property for an annuity are individuals that are selling family businesses to family members or to related trusts. We think that it would be particularly inappropriate to force a taxpayer in such a circumstance to recognize all of the gain in the asset in the year of the sale when the seller will receive the sales proceeds over the term of the annuity and the actual proceeds from the sale are contingent upon the remaining life of the seller.

In addition, as noted above, a taxpayer is generally not permitted to use the installment method of accounting if the purchaser is related to the seller and the

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[20] In this regard, Section 453 and the regulations issued thereunder permit a taxpayer to use the installment method of accounting even if the "note" that is issued in exchange for the sold property does not constitute debt for U.S. federal income tax purposes, with an exclusion for certain equity or equity-like interests. See, e.g., Treasury Regulations Section 15a.453-1(c)(1) and -1(c)(4). Accordingly, the fact that an annuity will generally not qualify as debt for tax purposes (because of the possibility that the annuitant will not receive back its investment in the annuity) should not preclude the application of the installment method of accounting to an exchange of property for an annuity.

purchaser sells the property within two years of the original sale of the property. Furthermore, as noted above, Section 453A of the Code imposes an interest charge in respect of taxpayers that hold notes that are subject to the installment method of accounting with an aggregate principal amount in excess of $5 million. We therefore think that the abusive transactions noted in the preamble to the Proposed Regulations would be substantially addressed if a taxpayer is subject to the Section 453 installment sale rules in respect of an exchange of property for an annuity.[21]

As discussed above, the IRS has ruled that a self cancelling installment note, which is similar to an annuity, is generally subject to the installment sale rules rather than the annuity rules described above as long as the maximum term of the note does not exceed the life expectancy of the holder of the note. The application of the installment sale rules to annuities that are issued in exchange for property would have the advantage of imposing the same set of tax rules to similar financial instruments. We further recommend in this regard that the final regulations provide that self canceling installment notes and annuities that are issued in exchange for property will be treated in the same manner and will be subject to the same rules for federal income tax purposes.

As discussed above, under current law, a taxpayer that sells property for a secured or commercial annuity is generally required to recognize gain or loss as of the date of the sale based on the value of the annuity at such time. We do not think that there is a compelling policy reason to distinguish between such annuities and other types of

[21] Alternatively, under a more modest approach, the abusive transactions that are described in the preamble to the Proposed Regulations might be addressed by retaining the current ratable basis recovery accounting rules for annuities while adding specific anti-abuse provisions in the final regulations that are similar to the anti-abuse provisions that are included in Sections 453 (in particular Sections 453(e) and 453A). This would result in rules that are similar in effect to the rules that we recommend be adopted in this report, except that the issuer of the annuity would not receive an interest deduction.

annuities and we therefore think that an exchange of property for such an annuity should also be subject to the installment sale rules of Section 453 of the Code. We note in this regard that the installment sale rules are available in the case of a taxpayer that sells property in exchange for an installment note that is issued by a commercial issuer/purchaser and we do not think that a different rule should apply to the same transaction just because the future payment right is in the form of an annuity rather than in the form of a traditional installment note. Furthermore, many secured annuities would in any case not be eligible for installment sale treatment under Section 453 because Section 453 prohibits the use of the installment method of accounting in the case of an installment note that is secured directly or indirectly by cash or a cash equivalent (such as a bank certificate of deposit or a treasury note).[22] Accordingly, an exchange of property for a secured annuity would continue to be subject to current taxation even if the final regulations adopt our recommendation that such a transaction should be subject to the Section 453 rules governing installment sales.[23]

We have considered whether the application of Section 453 to the sale of property in exchange for an annuity is contrary to the Congressional intent in enacting Section 453. More specifically, the legislative history to Section 453 states that Section 453 "does not deal directly" with private annuities.[24] We think that this statement should not be interpreted to mean that Congress intended that Section 453 should in no event apply to annuities, but rather that the statutory language does not explicitly apply to

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22 Treasury Regulations Section 15a.453-1(b)(3)(i).

23 On the other hand, if Treasury and the IRS concluded that it is desirable to apply Section 453 to annuities generally but to exclude secured and/or commercial annuities from the application of Section 453, the "payment" definition in Treasury Regulations Section 15a.453-1(b)(3)(i) might be expanded to achieve this exclusion.

24 H.R. Rep. No. 96-1042, at 10 (1980); S. Rep. No. 96-1000 at 12 (1980).

annuities. We agree with the IRS' position in GCM 39503 (May 7, 1986) that the aforementioned legislative history "does not mean that private annuities are not installment sales; rather it was meant to leave room for the Service to determine what constitutes an installment sale and what constitutes a private annuity."

B. Election Out of Installment Method of Accounting

If a taxpayer exchanges property for an annuity and elects out of the installment method of accounting in respect of the exchange, then we think that the taxpayer should be treated in the manner set forth in the Proposed Regulations under which the taxpayer would recognize immediate gain or loss in respect of the sale based on the fair market value of the annuity at the time of the sale as determined under Section 7520 of the Code. In such a case, we agree with the approach of the Proposed Regulations under which the seller will be subject to the general rules governing annuities under Section 72 in respect of all payments that it receives under the annuity and will be treated as having invested an amount in the annuity that is equal to the amount that it realized in respect of the sale of the property.

C. Application of Installment Method of Accounting to Annuities

The following section addresses the technical application of the installment method accounting rules to an exchange of property for an annuity and is premised upon the assumption that the final regulations will adopt our recommendation that a taxpayer would be permitted to account for such an exchange under the installment method of accounting under Section 453 of the Code.

As discussed above, the application of the installment sale rules to a transaction in which the amount that will be received by the taxpayer cannot be determined by the close of the taxable year in which the sale takes place depends on

whether the purchase price has a stated maximum selling price or there is a maximum period over which the purchase price could be received. If a contingent payment sale is treated as having a maximum stated selling price, then the maximum stated selling price is treated as the selling price for purposes of applying the general installment sale rules. If a contingent payment sale does not have a maximum stated selling price, but the maximum period over which payments may be received under the sales agreement is fixed, the taxpayer's basis must be allocated to the taxable years in which payment may be received under the agreement in equal annual increments. If the agreement neither specifies a maximum selling price nor limits payments to a fixed period, the taxpayer's basis is generally required to be recovered in equal annual increments over a period of 15 years commencing with the date of sale.

An annuity that is issued in exchange for property does not technically have a maximum stated selling price or a maximum period over which payments may be received because there is no specified date by which a taxpayer is certain to die. Thus, in the absence of any specific rules with respect to annuities, a taxpayer would generally be required to recover its basis in equal annual increments over a period of 15 years commencing with the date of the sale. We recommend, however, that the final regulations include a rule that would treat the annuity as having a maximum stated selling price that is equal to the amount that the taxpayer is projected to receive under the annuity pursuant to the tables that are issued under Section 7520 of the Code (without taking into account the discount factor that is used to determine the value of the annuity for Section 7520 purposes).[25]

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[25] Alternatively, the annuity could be treated as having a maximum stated selling price that is equal to the amount the taxpayer is projected to receive under the annuity pursuant to the actuarial projections that are issued under Section 72 of the Code.

Although the projected amounts to be received by the taxpayer under the Section 7520 valuation methodology could in certain circumstances significantly differ from the actual amount that the taxpayer is projected to receive under the annuity (because the taxpayer's actual projected life expectancy may differ from the actuarial projected life of the taxpayer), we think that this methodology is more logical and appropriate than a rule that simply requires the taxpayer to recover its basis over a 15 year period irrespective of the age of the taxpayer. Furthermore, the fact that the Section 7520 tables will apply to determine the amount realized by a taxpayer that exchanges property for an annuity and elects out of the installment method of accounting provides further support for the position that the same valuation methodology should also be used for purposes of applying the installment method of accounting to such an exchange. Finally, if this proposal is adopted, we also recommend that the final regulations provide that an annuity that is issued in exchange for property be treated having a principal amount that is equal to the maximum stated selling price of the annuity for purposes of applying the Section 453A interest charge rules to the transaction.[26]

As discussed above, we recommend that a taxpayer that sells property in exchange for annuity should be subject to the general Section 453 rules governing installment sales. We therefore recommend that the final regulations clarify that the

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[26] We understand that a number of taxpayers take the position, based on the wording of Section 453(c)(6), that the Section 453A interest charge rules do not apply to contingent payment sales absent the issuance of regulations. We also note that, in the case of taxpayers who do apply Section 453A to contingent payment sales, the installment sale rules do not provide any mechanism under which a taxpayer that paid a Section 453A interest charge can obtain a refund of the interest paid if the amount ultimately received by the taxpayer under the installment sale is less than the amount the taxpayer was presumed to receive for purposes of applying the Section 453A interest charge. These issues relate to all contingent installment sales (rather than just annuities that are issued in exchange for property) and are beyond the scope of this report. We recommend, however, that the Treasury Department and IRS issue guidance that addresses these anomalies.

accounting rules for annuities under Section 72 of the Code will not apply to the annuity that is held by the taxpayer.

D. Tax Treatment of Issuer

As noted above, the preamble to the Proposed Regulations requested comments regarding the tax treatment of the issuer of an annuity in exchange for property. We recommend that the final regulations provide that the issuer of the annuity will be treated for tax purposes in the same manner as a purchaser of property under a contingent payment installment sale. Specifically, the regulations should provide that the issuer of the annuity will not immediately obtain a fair market value basis in the sold property but rather will only obtain tax basis as the annuity payments are made.[27]

In addition, the final regulations should provide that, as is the case in respect of the purchaser in a contingent installment sale, the annuitant and the issuer of the annuity will be required to treat a portion of each annuity payment as interest based on the "applicable federal rate" that is in effect on the date of the sale.[28] This will differ from the current treatment of an issuer of annuity in exchange for property that uses the ratable basis recovery accounting method because, as discussed above, such an issuer is not permitted to treat any portion of the annuity payments as interest for tax purposes.

E. Death of Annuitant

We also recommend that the final regulations clarify that the death of the annuitant will not be treated as a disposition of the annuity for Section 453B purposes.

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[27] *See, e.g.*, *David R. Webb Co.* v. *Commissioner*, 708 F.2d 1254 (7th Cir. 1983); *Albany Car Wheel* v. *Commissioner*, 333 F.2d 653 (2d Cir. 1964).

[28] *See* IRC Section 483 and Treasury Regulations Section 1.483-1. The OID and contingent debt obligation rules will generally not apply to impute interest in respect of the annuity because, as noted above, an annuity will generally not qualify as a debt instrument for U.S. federal income tax purposes.

The death of the seller should thus not cause the seller or the estate of the seller to recognize gain in respect of cash that it has not received, and the issuer of the annuity should correspondingly have a tax basis in the sold property that is equal to the aggregate payments made under the annuity.[29] As is the case in respect of contingent installment sales, the seller should recognize a loss in an amount equal to its unrecovered basis in the sold property if the seller dies before the annuity has paid the stated maximum selling price.

F. Section 7520 Valuation Methodology

As discussed above, we believe that a taxpayer that exchanges property for an annuity and elects out of Section 453 treatment should generally be treated in the manner set forth in the Proposed Regulations under which the taxpayer would recognize gain or loss in respect of the sale based on the fair market value of the annuity at the time of the sale as determined under Section 7520 of the Code. The preamble to the Proposed Regulations requested comments regarding whether the fair market value of the annuity should be determined in a manner other than under Section 7520 of the Code. We agree with the Proposed Regulations that the Section 7520 valuation tables should be used for purposes of determining the value of an annuity that is received in exchange for property. We acknowledge that this valuation method will overstate or understate the gain or loss that is recognized in connection with such a sale to the extent that the actual life expectancy of the annuitant differs from the actuarial projected life expectancy of the annuitant under Section 7520. For the reasons set forth below, however, we think that the Section 7520 valuation is the best methodology among the available alternatives.

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[29] This would differ from the case law governing self cancelling installment notes in which the courts held that the death of the holder of the installment note should be treated as a disposition of the installment note for Section 453B purposes. *See e.g., Frane Est. v. Commissioner*, 98 T.C. 341 (1992) *rev'd*, 998 F.2d 567 (8th Cir. 1993).

First, in enacting Section 7520, Congress expressed its position that the Section 7520 methodology should generally be used to value an annuity notwithstanding that such a valuation method will in certain cases overstate or understate the true fair market value of the annuity. Second, we think that a rule that would allow taxpayers to independently value the annuity based on the projected life expectancy of the annuitant would be subject to abuse and would not be administratively feasible. We similarly think that it would not be appropriate to require taxpayers to obtain an appraisal of the value of the annuity. Finally, we think that the fact that actuarial projections are used to determine the income exclusion ratio applicable to annuities under Section 72 of the Code further supports the position that an objective valuation methodology should also be used to value an annuity that is issued in exchange for property.

G. Reporting Obligations

We also recommend that the final regulations provide that a taxpayer that is subject to the installment method of accounting in respect of an exchange of property for an annuity should be required to file IRS Form 6252 in the same manner as other taxpayers that are subject to the installment method of accounting.

H. Application of Installment Method to Annuities Isssued by Charitable Organizations

As noted above, the Proposed Regulations generally do not apply to an annuity that is issued by a charitable organization in connection with a bargain sale of property to the charity. Rather, the ratable basis recovery accounting method set forth under Treasury Regulations Section 1.1011-2 will generally continue to apply to the holder of the annuity. The preamble to the Proposed Regulations, however, requested comments as to whether this method of accounting should continue to apply to annuities that are issued by a charitable organization.

We do not have a strong view as to whether the final regulations should provide that the installment sale rules described above, rather than the ratable basis recovery accounting method, should also apply to annuities that are issued by a charitable organization in connection with a bargain sale of property to the charity. We would, however, note certain considerations that we believe should be taken into account by the IRS and Treasury Department in considering the tax treatment of annuities that are issued by charitable organizations.

Specifically, we think that that the IRS and Treasury Department should consider that there are tax policy reasons that may support the position that a seller/annuitant should be entitled to use the ratable basis recovery accounting method in respect of bargain sales to charitable organizations. First, the more advantageous basis recovery method could be used to encourage contributions to charity through the mechanism of a bargain sale of property to charitable organizations in exchange for an annuity. Second, the abuse potential of the ratable basis recovery method described above (e.g., sale to a related party followed by a disposition of the sold property) will generally not apply in the case of a bargain sale of property to a charitable organization.

On the other hand, we think that that the IRS and Treasury Department should also consider whether it is appropriate to apply special tax accounting rules to annuities that are issued by a charity in the absence of any legislative directive, or whether such a policy position should be adopted in the first instance by Congress.[30] We also note that complexities may arise from the operation of two parallel taxing regimes.

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[30] We think, however, that any final regulations that do make such a distinction would be within the scope of the regulatory authority that is granted to the Treasury Department and the IRS. Our view in this regard is based on the fact that, as discussed above, Section 453(j)(2) and the legislative history to Section 453 seem to have granted broad authority to the Treasury Department and the IRS to decide whether and to what extent the Section 453 rules should apply to annuities that are issued in exchange for property.