

COMMENTS

CHARITABLE ANNUITIES: COST AND CAPITAL GAIN IN LIGHT OF 1962 REVENUE RULINGS

It is not an uncommon practice today for charitable institutions to issue annuities.¹ In the typical case, a person, often in a high income bracket, offers to make a substantial contribution to a charity in return for the promise of the charity to pay him an annuity for life. There is usually no bargaining since the money or property offered by the donor is generally of much greater value than the annuity he expects from the charity. Consequently, the transaction includes both a purchase of an annuity contract and a gift to the charity.² For the purposes of the transaction between the charity and the donor, it is not necessary to distinguish between the value or cost of the annuity received and the value of the gift donated. Such an allocation must be made, however, for two tax purposes.

The *cost* of an annuity is an essential element in the determination of income tax liability on the annuity payments.³ Due to the nature of the transaction, the cost of a charitable annuity is much more difficult to determine than that of an ordinary commercial annuity, the cost of the latter simply being the total consideration paid.

A determination of the *value* of an annuity is necessary in order to determine capital gains tax liability. Often, instead of giving cash, the donor will transfer some type of appreciated property to a charity in return for the annuity. If a capital gains tax is to be computed on the transfer, the annuity must be given a fair market value. Whether a charitable annuity can be given a present value

¹ See Moorhead, *Annuity and Life Income Plans Offered by Charitable Organizations*, 10 J. AM. Soc'y C.L.U. 157 (1956).

² For example, suppose the donor transfers to a charity property worth \$80,000. In return the charity promises to pay him \$5,000 per year for life. The donor's life expectancy is ten years so that he could have purchased a \$5,000 life annuity from an insurance company for approximately \$50,000. He has in effect made a gift of approximately \$30,000 to the charity.

³ As explained *infra*, the cost of an annuity is an element in the "exclusion ratio" which is used to determine what part of the annuity payment is income and what part is a return of capital.

for this purpose and, if so, how to measure that value, are matters about which there has been some question.

The Internal Revenue Service has attempted to solve these problems with two revenue rulings which became effective September 6, 1962.⁴ Revenue Ruling 62-137 provides that commercial annuity rates are a proper standard for determining the cost of charitable annuities and sets out a cost-table based on these rates. Revenue Ruling 62-136 says that henceforth charitable annuities will be given a fair market value in order to fix an immediate capital gains tax liability on the property transfer. Furthermore, it indicates that the annuity cost-table provided in Revenue Ruling 62-137 will also be used to determine the fair market value. In simplest terms, these two rulings provide that the cost and fair market value of charitable annuities are equivalents and are to be determined by commercial annuity standards. However, since this valuation is to be used for two different purposes, it seems desirable to consider each ruling separately.

COST OF THE ANNUITY

Annuity payments are considered to be part income and part a return of capital so that for income tax purposes, it is necessary to determine the income portion of each payment.⁵ Since the Revenue Act of 1954 the calculation of the income portion has been based on an "exclusion ratio."⁶ That is to say, a ratio, or percentage, is determined by dividing the total expected return from the annuity into the *cost of the annuity*.⁷ That percentage of each payment is considered to be a return of capital and is "excluded" from taxable income.

However, there are at least two ways to figure the cost of a charitable annuity. One way is to treat the purchase of a charitable annuity like any arms length transaction and say that the cost is the

⁴ Rev. Rul. 62-136, 1962 INT. REV. BULL. No. 35, at 6; Rev. Rul. 62-137, 1962 INT. REV. BULL. No. 35, at 7, as supplemented by Rev. Rul. 62-216, 1962 INT. REV. BULL. No. 53, at 8.

⁵ 1 MERTENS, FEDERAL INCOME TAXATION, §§ 5.06, 6A.05 (1962 rev.).

⁶ INT. REV. CODE OF 1954, § 72 (b). For a historical analysis of the methods used to determine the income from an annuity for tax purposes see Murphy, *Federal Tax Treatment of Annuities*, 16 U. PITT. L. REV. 311 (1955).

⁷ INT. REV. CODE OF 1954, § 72 (b). The Code talks in terms of the "investment in the contract." Generally the investment in the contract is the cost of the annuity, and the two terms are used as equivalents herein.

total amount transferred to the charity.⁸ The other way is to recognize that a portion of the amount transferred to the charity was a gift, and another portion was consideration for the annuity.⁹ Revenue Ruling 62-137 takes the latter view and provides that the cost of the annuity is deemed to be that for which it could have been purchased from a commercial annuity company.¹⁰

It has been argued that commercial annuity rates should not be used to determine the cost of a charitable annuity. Charities will not issue an annuity at the commercial rate, and therefore it is said, the cost should be set at the higher actual rate of the charity.¹¹ Furthermore, the charity's rates should be higher, because it does not have the benefit of issuing large numbers of annuities. However, the charity is interested in gifts, as this line of argument seems to ignore, and not in selling annuities. The charity demands a higher price because it demands a gift before it will issue an annuity. Where it is clear that all of the amount paid was not the cost, it seems reasonable to use the current commercial market price to assign a cost to the annuity.

CAPITAL GAINS LIABILITY

Where there is a sale or other exchange of capital assets, the Internal Revenue Code generally provides that there is a capital

⁸ In *Beattie v. Commissioner*, 159 F.2d 788 (6th Cir. 1947), *affirming* 6 T.C. 609 (1946), the court held that all of the amount transferred to the charity was the cost of the annuity in spite of the admitted fact that it was the policy of such charities to issue no annuities where it was anticipated that more than 30% of the amount paid would be returned to the annuitant. *Accord*, F.A. Gillespie, 38 B.T.A. 673 (1938), *acq.*, 1939-1 CUM. BULL. 13.

Notice that the cost of the annuity varies inversely with the amount of the gift and varies directly with the exclusion ratio. Therefore, a taxpayer will argue for a higher cost of his annuity only if he is more interested in a lower tax on his annuity payments than he is in the amount of his charitable deduction.

⁹ This approach was adopted in *Anna L. Raymond*, 40 B.T.A. 244 (1939), *aff'd* 114 F.2d 140 (7th Cir.), *cert. denied*, 311 U.S. 710 (1940). *Accord*, *Gillespie v. Commissioner*, 128 F.2d 140 (9th Cir. 1942), *acq.*, 1941-1 CUM. BULL. 5.

¹⁰ Rev. Rul. 62-137, 1962 INT. REV. BULL. No. 35, at 7. Valuation tables based on commercial annuity rates are provided in the ruling to determine the commercial price of such an annuity. Tables for determining the commercial price of more complex types of annuities are provided in Rev. Rul. 62-216, 1962 INT. REV. BULL. No. 53, at 8.

¹¹ In *Anna L. Raymond*, 40 B.T.A. 244 (1939), *aff'd*, 114 F.2d 140 (7th Cir.), *cert. denied*, 311 U.S. 710 (1940), the taxpayer made this argument. At the time of this case, 3% of the cost of the annuity was taxed as ordinary income each year, and the remainder was excluded from income until the annuitant received a return of his investment untaxed. Here the issue was whether or not the taxpayer had already received a return of her cost. Had the issue been the amount of 3% of her cost, this argument would have been to the taxpayer's disadvantage.

gain to the extent that the value of the money or property received exceeds the adjusted basis of the property transferred.¹² If the consideration received in exchange is property other than money, a fair market value must be given the property to determine the capital gain.¹³ However, where the property is transferred for an annuity, and the purpose of the evaluation is to determine an immediate gain on the transfer, there is a question as to whether this obligation to make future payments can be given a fair market value.¹⁴

In the early case of *J. Darsie Lloyd*,¹⁵ a taxpayer transferred certain stock to his son in return for the son's promise to pay the taxpayer \$100,000 per year for life. The Commissioner determined an immediate capital gain on the transfer. The Board of Tax Appeals held that there was no immediately taxable gain since the obligor's future ability to pay was too uncertain to give the promise a present value.¹⁶

It is important to note that the Board recognized that a value could be ascertained for other tax purposes,¹⁷ but felt it unfair to charge the annuitant with an immediate gain when in fact his prospect of getting a return of his basis in the property, let alone any actual gain, was speculative. From this case the idea developed that an annuitant could not be charged with a capital gain until he had actually received from the annuity an amount equal to his basis in the property.

In the *Lloyd* case, the Board specifically distinguished the cases in which the obligor was an insurance company or a bank, pointing out that such institutions are financially sound and are regulated by law.¹⁸ The inference was that annuities of such institutions could be given a present value for immediate capital gains purposes. As

¹² INT. REV. CODE OF 1954, § 1001 (a).

¹³ INT. REV. CODE OF 1954, § 1001 (b).

¹⁴ Treas. Reg. § 1.1001-1 (1957) provides that "only in rare and extraordinary cases will property be considered to have no fair market value."

¹⁵ 33 B.T.A. 903 (1936), *nonacq.*, XV-2 CUM. BULL. 39 (1936), *nonacq. withdrawn and acq.*, 1950-2 CUM. BULL. 3.

¹⁶ *Accord*, Commissioner v. Kann's Estate, 174 F.2d 357 (3d Cir. 1949); Hill's Estate, 174 F.2d 357 (3d Cir. 1949); Hill's Estate v. Maloney, 58 F. Supp. 164 (D.N.J. 1944); Estate of Frank C. Deering, 40 B.T.A. 984 (1939), *nonacq.*, 1940-1 CUM. BULL. 6, *nonacq. withdrawn and acq.*, 1950-2 CUM. BULL. 2; Annot., 12 A.L.R.2d 589 (1950). *But see* Guaranty Trust Co., 15 B.T.A. 20 (1929); G.C.M. 1022, VI-I CUM. BULL. 12 (1927).

¹⁷ 33 B.T.A. at 904-05.

¹⁸ *Id.* at 905.

a result of the rationale in the *Lloyd* case, two lines of authority developed in the area of annuity taxation. There is no question that a present value can be given to the annuities of commercial insurance companies.¹⁹ However, courts have held that no such value can be placed on an annuity paid by an individual.²⁰ This latter view was extended by the Internal Revenue Service to charitable annuities,²¹ and it is this ruling which has now been reversed by Revenue Ruling 62-136.²²

TAX LIABILITY PRIOR TO THE RULING

Let us assume that, in a transaction occurring prior to the rulings, John Donor has certain stock with a tax basis of \$40,000 and a fair market value of \$80,000.²³ Yet us assume further that Donor

¹⁹ For example, courts hold that a commercial annuity purchased by an employer and given to his employee is present income to the employee to the extent of the fair market value of the annuity. *Hyde v. Commissioner*, 301 F.2d 279 (2d Cir. 1962) (dictum); *Elliott C. Morse*, 17 T.C. 1244 (1952), *aff'd*, 202 F.2d 69 (2d Cir. 1953); *Ward v. Commissioner*, 159 F.2d 502 (2d Cir. 1947); *Hackett v. Commissioner*, 159 F.2d 121 (1st Cir. 1946); *Oberwinder v. Commissioner*, 147 F.2d 255 (8th Cir. 1945); *Renton K. Brodie*, 1 T.C. 275 (1942); Rev. Rul. 55-691, 1955-2 CUM. BULL. 21; I.T. 4041, 1951-1 CUM. BULL. 5, *revoking* I.T. 2891, XIV-1 CUM. BULL. 50 (1935) and I.T. 1810, II-2 CUM. BULL. 70 (1923). For persuasive argument *contra* see the dissenting opinions of Arundell, J. and Turner, J. in *Elliott C. Morse*, 17 T.C. 1244, 1250, 1252 (1952). For a case where a commercial annuity was not present income see *Raymond J. Moore*, 45 B.T.A. 1073 (1941).

The question of valuation of commercial annuities comes up in connection with taxation of income and not capital gains. This is due to the fact that money and not appreciated property would generally be used to purchase a commercial annuity. The fact that commercial annuities are valued for income purposes and charitable annuities for capital gains purposes should make no difference since in each case the receiving of the annuity is a taxable present gain.

²⁰ *Commissioner v. Kann's Estate*, 174 F.2d 357 (3d Cir. 1949); *Hill's Estate v. Maloney*, 58 F. Supp. 164 (D.N.J. 1944); *Estate of Frank C. Deering*, 40 B.T.A. 984 (1939), *nonacq.*, 1940-1 CUM. BULL. 6, *nonacq. withdrawn and acq.*, 1950-2 CUM. BULL. 2; *J. Darsie Lloyd*, 33 B.T.A. 903 (1936), *nonacq.*, XV-2 CUM. BULL. 39 (1936), *nonacq. withdrawn and acq.*, 1950-2 CUM. BULL. 3; Rev. Rul. 239, 1953-2 CUM. BULL. 53; Annot., 12 A.L.R.2d 589 (1950).

²¹ There do not appear to be any cases in point where the issue was a capital gain from the exchange of property for a charitable annuity, but the Internal Revenue Service expressed this view in a letter ruling dated September 9, 1955. 4 P-H 1956 FED. TAX SERV. ¶ 76,312.

²² Rev. Rul. 62-136, 1962 INT. REV. BULL. No. 35, at 6. Even prior to this ruling it was necessary to value a charitable annuity for capital gains purposes. However, there was no immediate tax based on the valuation. The tax was not paid until the gain was actually received by the annuitant in excess of his basis of the property transferred.

²³ Notice that Donor may use part appreciated property and part non-appreciated property for the "purchase" of the annuity. However, in order for him to get the tax advantages from the transaction, the appreciated property should be designated as that which is donated to the charity as the gift. Otherwise, a court might find that

transfers this stock to X Charity in return for the promise of X to pay Donor \$5,000 per year for life. Donor's life expectancy is 12 years at the time of the transaction.

For income tax purposes an exclusion ratio is determined by dividing the amount of Donor's expected return from the annuity into his investment in the contract.²⁴ That ratio (or percentage) of each annual payment is received tax free as a return of capital.²⁵ In the given example, the expected return is \$60,000.²⁶ The amount of investment based on commercial annuity rates is \$54,000.²⁷ Thus, the exclusion ratio is 54,000/60,000 or 90%; \$4,500 (90% of \$5,000) of each \$5,000 is received tax free. Out of every payment Donor receives, \$500 is taxed as ordinary income.²⁸

In addition, a provision is made for Donor's capital gain.²⁹ After the excluded portion of the payments totals an amount equal to Donor's basis in the property transferred for the annuity, the excluded portion of the payments is taxed as capital gain until the total amount so taxed equals the difference between the tax basis of the property transferred and the fair market value of the annuity. If the value of the annuity is \$54,000, Donor has a capital gain of \$14,000 (\$54,000 less \$40,000).³⁰ Thus, in approximately nine years Donor will have received tax free a total of \$40,000—his tax basis.

the appreciated property was exchanged for the annuity and he realized a capital gain. However, it should be pointed out that such an allocation of the property might be disregarded if the Commissioner finds that in substance there was a single transfer of both kinds of property for the annuity. See the general rule concerning substance versus form in *Weiss v. White*, 265 U.S. 242 (1924).

²⁴ INT. REV. CODE OF 1954, § 72 (b).

²⁵ 1 MERTENS, *op. cit. supra* note 5, §§ 5.06, 6A.05.

²⁶ For the sake of simplicity here, the total expected return is determined by multiplying the life expectancy of the annuitant times the amount of each annual payment (12 x \$5,000). Table I, 26 C.F.R.; 1.72-9 is provided for determining the exact expected return in tax computations.

²⁷ This figure is taken for simplicity. It is approximately correct as compared to the rates of selected insurance companies and according to the table provided in Rev. Rul. 62-137, 1962 INT. REV. BULL. No. 35, at 7, 8. See 1 MERTENS, *op. cit. supra* note 5, § 6A.05, text accompanying note 46.

²⁸ Except for clarifying the determination of investment in the contract, the recent rulings have not changed this computation of income tax liability on the annuity payments.

²⁹ This discussion is concerned only with "long term" capital gains. INT. REV. CODE OF 1954, §§ 1101, 1201 (b), 1202.

³⁰ See note 27, *supra*.

Where a disposition is part gift and part purchase, current regulations apply all of the taxpayer's basis to the purchase in determining his gain. Treas. Reg. §§ 1001-1 (e), 1015-4 (1957). See, SURREY & WARREN, FEDERAL INCOME TAXATION 629 (1962 ed.).

At that point Donor will begin paying capital gains tax on the \$4,500 excluded portion until the total so taxed equals \$14,000. Then, Donor will return to the first formula whereby \$4,500 of each payment is tax free and \$500 is taxed as ordinary income.

TAX CONSIDERATIONS AFTER RULINGS

In some ways the present rulings have increased the annuitant's capital gains tax burden. The annuitant is now immediately taxed on a capital gain although he has not yet received from the transaction anything that he can use to pay the tax.³¹ Moreover, in some cases at least, the actual amount of capital gains tax paid may be greater than it would have been prior to the new ruling. Since the capital gains tax depends in part on the taxpayer's income tax rate,³² the capital gains tax may be more if his tax bracket is higher at the time of the transaction than it is at the time the payments are made. The taxpayer also loses the advantage of being able to spread the capital gain out over a period of years. If the taxpayer adds half the gain to his income, the effective rate of the tax may be as low as ten per cent. If he must absorb the entire gain in one year, his taxing bracket may be higher. As a further consideration, by making the annuitant immediately liable, there is no longer the possibility that all or part of the capital gains tax may be avoided by the death of the annuitant before he has lived out his life expectancy.³³

There is at least one aspect of the ruling that seems to ease the burden on the taxpayer and simplify computation of the tax. After the capital gains tax has been paid in the first year, the annuitant's tax liability on the annual payments will never change. Each year the proportion of the annual payments equal to the exclusion ratio will be tax free, and the remainder will be taxed as ordinary income. Under the former system of taxing the gain from a charitable annuity, the excluded portion of each payment was at first tax free, then for a period of years the excluded portion was taxed as capital gain, and after the capital gains tax was paid, the taxpayer returned to the

³¹ As pointed out *infra* the capital gains tax may be offset by a charitable deduction so that there will be no net tax paid on the transaction during the current year.

³² INT. REV. CODE OF 1954, §§ 1201 (b), 1202.

³³ Prior to the ruling Donor would have paid a capital gains tax beginning in the ninth year and continuing through the twelfth year. If he had died after ten years no capital gains tax would be paid on \$9,000 (2 x \$4,500). If he had died after eight years no capital gains tax would be paid at all.

original formula. In other words, a person who used the annuity for retirement income paid taxes only on perhaps ten per cent of each annuity payment for a few years. Then he became liable for a tax on all of it at a time when he might be less able to pay. This change in the net tax liability on the annuity payments seems to be an undesirable aspect of the former system.

The rulings have left some of the tax consequences of the charitable annuity transaction unchanged. One important consequence of this exchange is that the donor gets a charitable deduction from the transfer equal to the excess of the fair market value of the property transferred over the consideration paid for the annuity.³⁴ Thus, in the given hypothetical case Donor would have a charitable deduction in the current year of \$26,000 (\$80,000 less \$54,000) along with the immediate capital gains tax liability. Provided Donor is entitled to deduct all of the donation,³⁵ this deduction would more than offset the capital gains tax so that there would be no net tax paid on the transaction during the current year.³⁶

SOUNDNESS OF THE RULING AS TO CAPITAL GAINS

The ruling reverses the former policy of the Internal Revenue Service on the taxability of the capital gain from a transfer of appreciated property for a charitable annuity.³⁷ When such a reversal of revenue policy is made, it can be expected to come under attack in the courts.

³⁴ Treas. Reg. § 1.170-2(a)(3)(i) (1958); Treas. Reg. § 1.170-1(c) (1958).

³⁵ A taxpayer is entitled to a charitable deduction of only twenty or thirty per cent of his adjusted gross income depending on the kind of charity. INT. REV. CODE OF 1954, § 170(b).

³⁶ If Donor were in an 80% tax bracket, his tax saving on the \$26,000 deduction would be \$20,800 (80% of \$26,000). This would more than compensate for the immediate capital gains tax on \$14,000. Since the maximum capital gains rate is 25%, that tax liability would be \$3,500 (25% of \$14,000). Of course, the deduction could not exceed the percentage limitations outlined in INT. REV. CODE OF 1954, § 170(b).

Notice also the additional advantage the taxpayer gets by making the donation in appreciated property. Donor is allowed a deduction from gross income even though he has never been credited with the amount as income and even though he has never paid any tax on the total amount deducted. For example, Donor gets a deduction of \$26,000 even though the \$26,000 donated was property and not a part of his income. If he were in an 80% tax bracket Donor would save \$20,800 (80% of \$26,000) in income taxes. In addition, he would avoid paying \$6,500 (25% of \$26,000) in capital gains tax. In fact Donor is \$1,300 (\$20,800 plus \$6,500 less \$26,000) better off than if he had sold the property, and the charity has received \$26,000.

³⁷ Compare Rev. Rul. 62-136, 1962 INT. REV. BULL. No. 35, at 6 with 4 P-H 1956 FED. TAX SERV. ¶ 76,312 (letter ruling dated Sept. 9, 1955).

At the outset, the ruling may be attacked on the grounds that there is no market for charitable annuities, and thus, no fair market value. However, it is not always necessary that there be an established market to justify the establishment of a fair market value.³⁸ The crucial question is whether charities are sufficiently certain to be able to pay the annuity that the charitable annuity may reasonably be valued by a commercial standard.³⁹

Charities generally are not as closely regulated as insurance companies,⁴⁰ and, as a group, are probably somewhat more likely to be unable to meet their annuity obligations.⁴¹ There are notable exceptions to this statement, perhaps serving to illustrate the great diversity in the fiscal soundness of various charities. There is little difference, in the likelihood of inability to pay, between the well endowed university and a commercial insurance company, but substantial difference between these two entities and a small college or religious society. On the other hand, most charitable annuities are issued by the larger charities—established institutions,⁴² and from a practical point of view their present value may reasonably be taken as that of a commercial annuity.⁴³

³⁸ *Guggenheim v. Rasquin*, 312 U.S. 254 (1941) (valuation of a single premium life insurance policy).

In the following cases commercial annuities were given a value for income purposes even though they had no loan or cash surrender value and were not transferable. *Hackett v. Commissioner*, 159 F.2d 121 (1st Cir. 1946); *Elliott C. Morse*, 17 T.C. 1244, *aff'd*, 202 F.2d 69 (2d Cir. 1953).

³⁹ See *Burnet v. Logan*, 283 U.S. 404 (1931) (right to profits from mining operation), and cases cited in note 20, *supra*, for cases where no fair market value was found.

⁴⁰ D'Amours, *State Supervision of Charities: Present Status*, 4 N.H.B.J. 76 (1962).

⁴¹ If the obligor of an annuity becomes insolvent, the annuitant would seem to have a deductible loss if the court finds that the purchase of the annuity was a "transaction entered into for profit" under INT. REV. CODE OF 1954, § 165 (c) (2).

See *George M. Cohan*, 11 B.T.A. 743, 759 (1928); I.T. 3567, 1942-2 CUM. BULL. 105, as modified by Rev. Rul. 61-201, 1961-2 CUM. BULL. 46, finding the purchase of an annuity to be a transaction entered into for profit.

But see, *Early v. Atkinson*, 175 F.2d 118, 122 (4th Cir. 1949); *Evans v. Rothensies*, 114 F.2d 958, 962 (3d Cir. 1940); *Industrial Trust Co. v. Broderick*, 94 F.2d 927, 930 (1st Cir. 1938).

⁴² The 26 charities registered in New York to issue charitable annuities in 1960 had total assets of \$39,827,486 and total liabilities of \$25,986,359. While the total assets of most insurance companies is much greater than that of most charities, the ratio of assets to liabilities of the two seem to be comparable. 1961-1 N.Y. INS. REP. 333a, Life Table 18: "Charitable Annuity Societies 1960." See Moorhead, *Annuity and Life Income Plans Offered by Charitable Organizations*, 10 J. AM. Soc'y C.L.U. 157 (1956).

⁴³ An important question seems to be whether the table will be applied where there is reasonable doubt as to the ability of the charity to make the payments under the annuity. It is doubtful that the table would be held to be conclusive; such a ruling would raise constitutional questions as a conclusive presumption of fact. *Heiner v. Donnan*, 285 U.S. 312 (1932); *Nourse v. Riddell*, 143 F. Supp. 759, 762 (S.D. Cal. 1956).

However, it may be argued that there is involved here a fundamental principle, the change of which is better left to Congress than to the Commissioner.⁴⁴ This provision for capital gains is in effect taxing income to be received in the future. There is likely to be no market for the annuity so that the annuitant has received nothing that he can use to increase his purchasing power today. If he should die before receiving annuity payments totaling an amount equal to his basis in the property transferred to the charity, he will actually receive no monetary gain at all—even though he has already paid a tax on a substantial capital gain. It may further be argued that if the ruling of the Commissioner is accepted by the courts, it will open the door to immediate taxation of other types of deferred payments heretofore untouched by taxation until actually received by the payee. Family annuities, for example, are much like charitable annuities in some respects, but an extension of the principle of this ruling to family annuities would seem to be unjustified.⁴⁵ This principle might be a basis for imposing immediate tax liability on deferred payment contracts of executives and athletes even though the payments might never be actually received.⁴⁶ All of

It is clear that revenue rulings are only statements of policy by the Commissioner and are not binding on the courts. *Biddle v. Commissioner*, 302 U.S. 573, 582 (1938). However, the Commissioner will probably base his findings in the particular case on the table, and the findings of the Commissioner are prima facie correct. *Estate of Charles H. Hart*, 1 T.C. 989 (1943). The taxpayer would then have the burden of showing that the finding was inaccurate in the particular case. *Welch v. Helvering*, 290 U.S. 111 (1933). In general, it seems that using the table to determine the present value of the charitable annuity is reasonable. However, the taxpayer should be given an opportunity to show that it should not be applied in his particular case.

⁴⁴It has recently been proposed that Congress provide that all private annuities be given a fair market value in accordance with commercial annuity rates so that a capital gain can be determined. Apparently the intention would be to have an immediate capital gain on the transfer of appreciated property for charitable or family annuities. *Hearings on the Tax Recommendations of the President, Before the House Committee on Ways and Means*, 88th Cong., 1st Sess., pt. 1, at 140 (1963).

⁴⁵Both family annuities and charitable annuities have private obligors, and both are relatively free from governmental regulation. However, family annuities are different from both commercial and charitable annuities in that the obligor is a private individual rather than an established institution. This distinction has been clearly recognized by the court. See note 16, *supra* and accompanying text. It is also clear that the premise upon which the recent rulings are based is not applicable in the case of family annuities. While there is a reasonable certainty that both the insurance company and the charitable institution will be able to meet their annuity obligations, the same is not true where the obligor is an individual. Whether he will continue to be able to meet his annuity obligations during the lifetime of the annuitant is quite uncertain.

⁴⁶Up to now these questions have been met in terms of constructive receipt. See Rev. Rul. 60-31, 1960-1 CUM. BULL. 174. The critical point seems to be whether there

these transactions involve policy questions,⁴⁷ and arguably it should be the legislature which determines whether or not these transactions are to be encouraged or discouraged by tax policies.⁴⁸

CONCLUSION

The revenue ruling pertaining to the cost of the annuity is just a restatement of the already generally accepted view⁴⁹ and does not pose a serious conflict with existing case law. It simplifies annuity taxation in that it should resolve all doubts as to the cost of a charitable annuity. Moreover, it is not likely to encounter strenuous opposition from taxpayers since in most cases the lower cost is to the taxpayer's advantage—he gets a large charitable deduction in the current year though having to pay income tax on a larger portion of the payments received in the future.

The ruling as to capital gains taxation constitutes a reversal of Internal Revenue Service policy. From a purely legal point of view, this change is defensible; from a policy point of view, it can be questioned. It is fairly clear that the new policy makes this area of capital gains taxation simpler and more certain. The capital gains tax liability in these transactions will not have to be computed over a period of years. Moreover, since the capital gains tax is paid immediately, there can be no avoidance of the tax by the death of the

is an absolute right to the payment. Arguably, there are no more contingent factors in many of these contracts than there are in the case of a charitable annuity.

⁴⁷ One question is whether tax policy should encourage or discourage this type of transaction. Aside from whether these contracts actually have a fair market value, it may be good social policy to encourage people to provide themselves with an income in later years or to allow a person, who by virtue of the nature of his work will have a high income for only a short time, to spread this income out over a period of years.

In considering Revenue Ruling 62-136 there is also the question of tax policy favoring charitable donations. Since the donor must have independent funds available to pay the immediate capital gains tax, the amount of his gift is likely to be less than it otherwise would have been. Thus, the result is that charities, as well as donors, are adversely affected by the ruling.

⁴⁸ In the leading case of *Burnet v. Logan*, 283 U.S. 404 (1931), the court approved a finding of a fair market value of future profits from a mining operation for estate tax purposes but not for income tax purposes. Even though the payments were very uncertain, they could be valued in the former case because otherwise the estate could not be taxed at all. There was no such necessity in the latter case because the income could be taxed as the taxpayer received it.

On this basis the "purchaser" of a charitable annuity could argue that there is no necessity of finding a speculative value here since the capital gain may be taxed on the payments received after he has recovered his basis. On the other hand, the Commissioner can argue that there is a necessity here since the annuitant may die before recovering his basis, and therefore, no capital gains tax will be paid.

⁴⁹ See 1 MERTENS, *op. cit. supra* note 5, at § 6A.05, text accompanying note 46.

annuitant prior to the end of his life expectancy. On the other hand, the new policy requires that a present value be given to the annuity for an immediate tax. Even if the proposed valuation tables are accepted by the courts for financially sound charities, the problem of the small or instable charity remains.