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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-141901-05

RIN 1545-BE92

Exchanges of Property for an Annuity

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance on the taxation of the exchange of property for an annuity contract. These regulations are necessary to outline the proper taxation of these exchanges and will affect participants in transactions involving these exchanges. This document also provides notice of public hearing.

DATES: Written or electronic comments must be received by January 16, 2007. Outlines of topics to be discussed at the public hearing scheduled for February 16, 2007, at 10 a.m. must be received by January 16, 2007.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-141901-05), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered to CC:PA:LPD:PR (REG-141901-05), Courier’s Desk, Internal Revenue Service, Crystal Mall 4 Building, 1901 S. Bell St., Arlington, VA, or sent electronically, via the IRS internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS and REG141901-05).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, James Polfer, at (202) 622-3970; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Kelly Banks, at (202) 622-0392 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations.

Section 1001 of the Internal Revenue Code (Code) provides rules for determining the amount of gain or loss recognized. Gain from the sale or other disposition of property equals the excess of the amount realized therefrom over the adjusted basis of the property; loss from the sale or other disposition of property equals the excess of the adjusted basis of the property over the amount realized. Section 1.1001-1(a) of the Income Tax Regulations provides further that the exchange of property for other property differing materially either in kind or in extent is treated as income or as loss sustained. Under section 1001(b), the amount realized from the sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. Except as otherwise provided in the Code, the entire amount of gain or loss on the sale or exchange of property is recognized.

Under section 72(a), gross income includes any amount received as an annuity (whether for a period certain or for the life or lives of one or more individuals) under an annuity, endowment, or life insurance contract. Section 72(b) provides that gross income does not include that part of any amount received as an annuity which bears the same ratio to such amount as the investment in the contract bears to the expected return under the contract. Under section 72(e), amounts received under an annuity contract before the annuity starting date are included in gross income to the extent allocable to income on the contract, and are excluded from gross income to the extent allocable to the investment in the contract. Investment in the contract is defined in section 72(c) as the aggregate amount of premiums or other consideration paid, reduced by amounts received before the annuity starting date that were excluded from gross income.

In Lloyd v. Commissioner, 33 B.T.A. 903 (1936), nonacq., XV-2 CB 39 (1936), nonacq. withdrawn and acq., 1950-2 CB 3, the Board of Tax Appeals considered the taxation of gain from a father's sale of property to his son for an annuity contract. The Board concluded that the annuity contract had no fair market value within the meaning of the predecessor of section 1001(b) because of the uncertainty of payment from the son. Because the annuity contract had no fair market value under that provision, the Board held that the gain from the sale of the property was not required to be recognized immediately but rather would be included in income only when the annuity payments exceeded the property's basis. In reaching its holding, the Board applied the open transaction doctrine articulated by the Supreme Court in Burnet v. Logan, 283 U.S. 404 (1931). Under this doctrine, if an amount realized from a sale cannot be determined with certainty, the seller recovers the basis of the property sold before any income is realized on the sale.

In Rev. Rul. 69-74, 1969-1 CB 43, a father transferred a capital asset having an adjusted basis of $20,000 and a fair market value of $60,000 to his son in exchange for the son's legally enforceable promise to pay him a life annuity of $7,200 per year, in equal monthly installments of $600. The present value of the life annuity was $47,713.08. The ruling concluded that: (1) the father realized capital gain based on the difference between the father's basis in the property and the present value of the annuity; (2) the gain was reported ratably over the father's life expectancy; (3) the investment in the contract for purposes of computing the exclusion ratio was the father's basis in the property transferred; (4) the excess of the fair market value of the property transferred over the present value of the annuity was a gift from the father to the son; and (5) the prorated capital gain reported annually was derived from the portion of each annuity payment that was not excludible.

In Estate of Bell v. Commissioner, 60 T.C. 469 (1973), acq. in part and nonacq. in part, 1974 WL 36039 (Jan. 8, 1974), acq., AOD No. 1979-184 (August 15, 1979), a husband and wife transferred stock in two closely held corporations to their son and daughter and their spouses in exchange for an annuity contract.

The fair market value of the stock substantially exceeded the value of the annuity contract. The stock transferred was placed in escrow to secure the promise of the transferees. As further security, the annuity agreement provided for a cognovit judgment against the transferees in the event of default. Because of the secured nature of the annuity, the tax court held that (i) the difference between the value of the stock and the value of the annuity contract constituted a gift; (ii) the difference between the adjusted basis of the stock and the value of the annuity contract constituted gain that was taxable in the year of the transfer (which was not before the court); and (iii) the investment in the annuity contract equaled the present value of the annuity. Similarly, in 212 Corp. v. Commissioner, 70 T.C. 788 (1978), the tax court held that the entire amount of gain realized from the exchange of appreciated real property for an annuity contract was fully taxable in the year of the exchange because the annuity contract was secured by (i) an agreement that the annuity payments would be considered a charge against the rents from the property, (ii) an agreement not to mortgage or sell the property without written consent of the transferors, and (iii) the authorization of a confession of judgment against the transferee in the event of default.

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. 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. Many of these transactions involve a variety of mechanisms to secure the payment of amounts due under the annuity contracts.

The Treasury Department and the IRS believe that neither the open transaction approach of Lloyd v. Commissioner nor the ratable recognition approach of Rev. Rul. 69-74 clearly reflects the income of the transferor of property in exchange for an annuity contract. Contrary to the premise underlying these authorities, an annuity contract – whether secured or unsecured – may be valued at the time it is received in exchange for property. See generally section 7520 (requiring the use of tables to value any annuity contract for federal income tax purposes, except for purposes of any provision specified in regulations); §1.1001-1(a) ("The fair market value of property is a question of fact, but only in rare and unusual circumstances will property be considered to have no fair market value."). The Treasury Department and the IRS believe that the transferors should be taxed in a consistent manner regardless of whether they exchange property for an annuity or sell that property and use the proceeds to purchase an annuity.

Explanation of Provisions

These proposed amendments provide that, if an annuity contract is received in exchange for property (other than money), (i) the amount realized attributable to the annuity contract is the fair market value (as determined under section 7520) of the annuity contract at the time of the exchange; (ii) the entire amount of the gain or loss, if any, is recognized at the time of the exchange, regardless of the taxpayer's method of accounting; and (iii) for purposes of determining the initial investment in the annuity contract under section 72(c)(1), the aggregate amount of premiums or other consideration paid for the annuity contract equals the amount realized attributable to the annuity contract (the fair market value of the annuity contract). Thus, in situations where the fair market value of the property exchanged equals the fair market value of the annuity contract received, the investment in the annuity contract equals the fair market value of the property exchanged for the annuity contract.

In order to apply the proposed regulations to an exchange of property for an annuity contract, taxpayers will need to determine the fair market value of the annuity contract as determined under section 7520. In the case of an exchange of property for an annuity contract that is in part a sale and in part a gift, the proposed regulations apply the same rules that apply to any other such exchange under section 1001.

The proposed regulations provide that, for purposes of determining the investment in the annuity contract under section 72(c)(1), the aggregate amount of premiums or other consideration paid for the annuity contract is the portion of the amount realized on the exchange that is attributable to the annuity contract (which is the fair market value of the annuity contract at the time of the exchange). This rule is intended to ensure that no portion of the gain or loss on the exchange is duplicated or omitted by the application of section 72 in the years after the exchange. The annuitant's investment in the contract would be reduced in subsequent years under section 72(c)(1)(B) for amounts already received under the contract subsequent to the exchange and excluded from gross income when received as a return of the annuitant's investment in the contract.

The proposed regulations do not distinguish between secured and unsecured annuity contracts, or between annuity contracts issued by an insurance company subject to tax under subchapter L and those issued by a taxpayer that is not an insurance company. Instead, the proposed regulations provide a single set of rules that leave the transferor and transferee in the same position before tax as if the transferor had sold the property for cash and used the proceeds to purchase an annuity contract. The same rules would apply whether the exchange produces a gain or loss. The regulations do not, however, prevent the application of other provisions, such as section 267, to limit deductible losses in the case of some exchanges. The proposed regulations apply to exchanges of property for an annuity contract, regardless of whether the property is exchanged for a newly issued annuity contract or whether the property is exchanged for an already existing annuity contract.

Existing regulations in §1.1011-2 govern the tax treatment of an exchange of property that constitutes a bargain sale to a charitable organization (including an exchange of property for a charitable gift annuity). Example 8 in section 2(c) of those regulations provides that any gain on such an exchange is reported ratably, rather than entirely in the year of the exchange. This notice of proposed rulemaking does not propose to change the existing regulations in §1.1011-2. However, comments are requested as to whether a change should be made in the future to conform the tax treatment of exchanges governed by §1.1011-2 to the tax treatment prescribed in these proposed regulations.

The Treasury Department and the IRS are aware that property is sometimes exchanged for an annuity contract, including a private annuity contract, for valid, non-tax reasons related to estate planning and succession planning for closely held businesses. The proposed regulations are not intended to frustrate these transactions, but will ensure that income from the transactions is accounted for in the appropriate periods. In section 453, Congress set forth rules permitting the deferral of income from a transaction that qualifies as an installment sale. Taxpayers retain the ability to structure transactions as installment sales within the meaning of section 453(b), provided the other requirements of section 453 are met. The Treasury Department and IRS request comments as to the circumstances, if any, in which an exchange of property for an annuity contract should be treated as an installment sale, and as to any changes to the regulations under section 453 that might be advisable with regard to those circumstances.

Proposed Effective Date

The Treasury Department and the IRS propose §1.1001-1(j) to be effective generally for exchanges of property for an annuity contract after October 18, 2006. Thus, the regulations would not apply to amounts received after October 18, 2006, under annuity contracts that were received in exchange for property before that date. For a limited class of transactions, however, §1.1001-1(j) is proposed to be effective for exchanges of property for an annuity contract after April 18, 2007.

The Treasury Department and the IRS propose §1.72-6(e) to be effective generally for annuity contracts received in such exchanges after October 18, 2006. For a limited class of transactions, however, §1.72-6(e) is proposed to be effective for annuity contracts received in exchange for property after April 18, 2007. The Treasury Department and the IRS also propose to declare Rev. Rul. 69-74 obsolete effective contemporaneously with the effective date of these regulations. Thus, the obsolescence would be effective April 18, 2007, for exchanges described in §1.1001-1(j)(2)(ii) and §1.72-6(e)(2)(ii), and effective October 18, 2006, for all other exchanges of property for an annuity contract.

In both regulations, the effective date is delayed for six months for transactions in which (i) the issuer of the annuity contract is an individual; (ii) the obligations under the annuity contract are not secured, either directly or indirectly; and (iii) the property transferred in the exchange is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange. The Treasury Department and the IRS believe that the later proposed effective date for these transactions provides ample notice of the proposed rules for taxpayers currently planning transactions that present the least opportunity for abuse.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulation flexibility analysis is not required. This certification is based on the fact that typically only natural persons within the meaning of section 72(u) exchange property for an annuity contract. In addition, these regulations do not impose new reporting, recordkeeping, or other compliance requirements on taxpayers. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are timely submitted to the IRS. In addition to comments on the proposed regulations more generally, the Treasury Department and the IRS specifically request comments on (i) the clarity of the proposed regulations and how they can be made easier to understand; (ii) what guidance, if any, is needed in addition to Rev. Rul. 55-119, 1955-1 CB 352, see §601.601(d)(2), on the treatment of the issuer of an annuity contract that is not taxed under the provisions of subchapter L of the Code; (iii) whether any changes to §1.1011-2 (concerning a bargain sale to a charitable organization in exchange for an annuity contract), conforming those regulations to the proposed regulations, would be appropriate; (iv) circumstances (and corresponding changes to the regulations under section 453, if any) in which it might be appropriate to treat an exchange of property for an annuity contract as an installment sale; (v) circumstances, if any, in which the fair market value of an annuity contract for purposes of §1.1001-1(j) should be determined other than by tables promulgated under the authority of section 7520; and (vi) additional transactions, if any, for which the six month delayed effective date would be appropriate. All comments will be available for public inspection and copying.

A public hearing has been scheduled for February 16, 2007, at 10 a.m., in the auditorium, Internal Revenue Service, New Carrollton Building, 5000 Ellin Road, Lanham, MD 20706. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area lobby more than 30 minutes before the hearing starts. For information about having your name placed on the access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments by January 16, 2007, and submit an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by that same date.

A period of 10 minutes will be allotted to each person making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is James Polfer, Office of the Associate Chief Counsel (Financial Institutions and Products), Internal Revenue Service.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAX

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.72-6, paragraph (e) is added to read as follows:

<u>§1.72-6 Investment in the contract</u>.

* * * * *

(e) Certain annuity contracts received in exchange for property -- (1) In general. If an annuity contract is received in an exchange subject to §1.1001-1(j), the aggregate amount of premiums or other consideration paid for the contract equals the amount realized attributable to the annuity contract, determined according to §1.1001-1(j).

(2) Effective date -- (i) In general. Except as provided in paragraph (e)(2)(ii), this paragraph (e) is applicable for annuity contracts received after October 18, 2006, in an exchange subject to §1.1001-1(j).

(ii) This paragraph (e) is applicable for annuity contracts received after April 18, 2007, in an exchange subject to §1.1001-1(j) if the following conditions are met --

(A) The issuer of the annuity contract is an individual;

(B) The obligations under the annuity contract are not secured, either directly or indirectly; and

(C) The property transferred in exchange for the annuity contract is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange. For purposes of this provision, a disposition includes without limitation a transfer to a trust (whether a grantor trust, a revocable trust, or any other trust) or to any other entity even if solely owned by the transferor.

Par. 3. In §1.1001-1, paragraphs (h), (i) and (j) are added to read as follows:

§1.1001-1 Computation of gain or loss.

* * * * *

(h) [Reserved.]

(i) [Reserved.]

(j) Certain annuity contracts received in exchange for property -- (1) In general. If an annuity contract (other than an annuity contract that either is a debt instrument subject to sections 1271 through 1275, or is received from a charitable organization in a bargain sale governed by §1.1011-2) is received in exchange for property, receipt of the contract shall be treated as a receipt of property in an amount equal to the fair market value of the contract, whether or not the contract is the equivalent of cash. The amount realized attributable to the annuity contract is the fair market value of the annuity contract at the time of the exchange, determined under section 7520. For the timing of the recognition of gain or loss, if any, see §1.451-1(a). In the case of a transfer in part a sale and in part a gift, see paragraph (e) of this section. In the case of an annuity contract that is a debt instrument subject to sections 1271 through 1275, see paragraph (g) of this section. In the case of a bargain sale to a charitable organization, see §1.1011-2.

(2) Effective date -- (i) In general. Except as provided in paragraph (j)(2)(ii), this paragraph (j) is effective for exchanges of property for an annuity contract (other than an annuity contract that either is a debt instrument subject to sections 1271 through 1275, or is received from a charitable organization in a bargain sale governed by §1.1011-2) after October 18, 2006.

(ii) This paragraph (j) is effective for exchanges of property for an annuity contract (other than an annuity contract that either is a debt instrument subject to sections 1271 through 1275, or is received from a charitable organization in a bargain sale governed by §1.1011-2) after April 18, 2007, if the following conditions are met --

(A) The issuer of the annuity contract is an individual;

(B) The obligations under the annuity contract are not secured, either directly or indirectly; and

(C) The property transferred in exchange for the annuity contract is not subsequently sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange. For purposes of this provision, a disposition includes without limitation a transfer to a trust (whether a grantor trust, a revocable trust, or any other trust) or to any other entity even if solely owned by the transferor.

Deputy Commissioner for Services and Enforcement.