212 Corp. v. Commissioner, 70 T. C. 788 (1978); Estate of Schultz v. Commissioner, 70 T. C. 788 (1978)

When property is exchanged for a private annuity, the investment in the contract is the fair market value of the property transferred, and any resulting gain must be recognized in the year of the exchange if the annuity is secured.

Summary

Arthur and Madeline Schultz transferred appreciated real estate to 212 Corporation in exchange for a private annuity. The key issues were the valuation of the property and the timing of recognizing any capital gain from the exchange. The Tax Court ruled that the investment in the contract for tax purposes was the fair market value of the transferred properties, which was determined to be $169,603. 56, not the $225,000 contract price. The court also held that the resulting gain was taxable in the year of the exchange due to the secured nature of the annuity. This case clarifies the tax treatment of private annuities and the valuation of property in non-arm's-length transactions.

Facts

In 1968, Arthur and Madeline Schultz, aged 73, transferred two properties in Erie, PA, to 212 Corporation, a company owned by their sons and son-in-law, in exchange for a joint survivor annuity of $18,243. 74 per year. The contract specified a total purchase price of $225,000 for the properties. 212 Corporation leased the properties back to Arthur F. Schultz Co. , which was wholly owned by Arthur Schultz. The properties had an adjusted basis of $82,520. 57 for the Schultzes. Independent appraisals valued the properties significantly lower than the contract price, and the IRS challenged the valuation and tax treatment of the transaction.

Procedural History

The IRS issued a notice of deficiency to the Schultzes and 212 Corporation, asserting increased tax liabilities based on different valuations and tax treatments of the annuity and properties. The taxpayers petitioned the U. S. Tax Court, which heard the case and issued its opinion on August 31, 1978.

Issue(s)

1. Whether the investment in the contract for the purpose of computing the exclusion ratio under Section 72 is the fair market value of the property transferred or the value of the annuity received?
2. Whether the gain realized by the Schultzes on the transfer of the properties is taxable in the year of the exchange or ratably over their life expectancy?
3. What are the bases and useful lives of the properties transferred for purposes of computing 212 Corporation's allowable depreciation?

Holding

1. Yes, because the investment in the contract is the fair market value of the property transferred, which the court determined to be $169,603. 56, not the $225,000 contract price.
2. Yes, because the gain is taxable in the year of the exchange due to the secured nature of the annuity, resulting in a closed transaction.
3. The court determined the bases and useful lives of the properties for 212 Corporation's depreciation calculations.

Court's Reasoning

The court applied Section 72 to determine that the investment in the contract is the fair market value of the property transferred, not the value of the annuity received. The court rejected the taxpayers' argument that the contract price of $225,000 should be used, finding instead that the fair market value was $169,603. 56, based on the estate tax tables and the secured nature of the annuity. The court followed *Estate of Bell v. Commissioner*, holding that the gain was taxable in the year of the exchange because the annuity was secured by the properties and lease agreements, making it a closed transaction. The court also determined the bases and useful lives of the properties for depreciation purposes, considering the evidence presented and the nature of the assets. Dissenting opinions argued that the annuity had no ascertainable fair market value and that the gain should be recognized ratably over the life expectancy of the annuitants.

Practical Implications

This decision impacts how private annuities are valued and taxed, especially in non-arm's-length transactions. Attorneys should advise clients that when property is exchanged for a private annuity, the fair market value of the property, not the contract price, determines the investment in the contract for tax purposes. The ruling also clarifies that if the annuity is secured, the resulting gain is taxable in the year of the exchange, which may affect estate and income tax planning strategies. Practitioners should consider the implications for depreciation and the valuation of assets in similar transactions. Subsequent cases have referenced this ruling when addressing the tax treatment of private annuities and property valuations in related-party transactions.

