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## NO INTEREST DEDUCTION FOR PRIVATE ANNUITIES

— by Neil E. Harl\*

Although a 1929 case, *Commissioner v. Moore Corp.*,<sup>1</sup> had suggested that an interest deduction could be claimed by the obligor under a private annuity arrangement, cases considering the issue since that time have held that no part of the payments made under private annuities involving the acquisition of property is deductible as interest.<sup>2</sup> A 1992 decision by the U.S. Claims Court, *Rye v. United States*,<sup>3</sup> is in accord with the view that an interest deduction may not be claimed by the obligor and the imputed interest rules<sup>4</sup> likewise do not apply to private annuities.<sup>5</sup>

### Which rules govern private annuities?

An important issue in the determination of how private annuity payments are handled by the obligor (and by the annuitant) is which provisions govern private annuity transactions.<sup>6</sup>

Before the enactment of the Installment Sales Revision Act of 1980,<sup>7</sup> it was generally recognized that private annuities were taxed under the rules for annuities generally.<sup>8</sup> With that characterization, a substantial body of case law and rulings<sup>9</sup> had emerged over the years which had created a unique treatment for private annuities. Gain was spread over the expected life of the annuitant, the annuitant's income tax basis was recovered by application of the exclusion ratio and the remainder of the obligor's payments was reported as ordinary annuity income to the annuitant.<sup>10</sup> As noted, it was generally agreed that no interest deduction was available to the obligor.<sup>11</sup> In effect, the obligor was acquiring the property with payments of principal only.

The Installment Sales Revision Act of 1980,<sup>12</sup> however, added a definition of installment sales as —

"...the disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs."<sup>13</sup>

Such a broad statement would seem to cover private annuities. Moreover, the Senate Committee Report<sup>14</sup> states —

"...The Committee believes that a taxpayer should be permitted to report gain from a deferred payment sale

under the installment method even if the selling price may be subject to some contingency."<sup>15</sup>

The Senate Report then adds the statement —

"...a creation of a statutory deferred payment option for all forms of deferred payment sales significantly expands the availability of installment reporting to include situations where it has not previously been permitted."<sup>16</sup>

However, the Senate Report goes on to state —

"[a]nother technique for intra-family transfers involves the so-called 'private annuity' arrangement. The bill does not deal directly with this type of arrangement."<sup>17</sup>

The U.S. Claims Court in *Rye v. United States*<sup>18</sup> rejected the argument by the taxpayers that private annuities should be governed by the Installment Sales Revision Act of 1980 and endorsed the view articulated by the court in *Garvey, Inc. v. United States*<sup>19</sup> that the entire amount of each annuity payment constitutes part of the purchase price of the property as a capital expenditure.<sup>20</sup> Accordingly, no part is deductible as interest. That view is bolstered by the point that private annuity obligations are too indefinite to constitute indebtedness.<sup>21</sup> Thus, the full purchase price is a capital expenditure.<sup>22</sup>

### Conclusion

The message in all of this is that the private annuity is a unique property transfer concept, governed by its own peculiar rules. While there may be problems of characterization of a transaction as a private annuity,<sup>23</sup> an installment sale<sup>24</sup> or a self-cancelling installment note,<sup>25</sup> and some guidance has been provided as to principles which should govern in that characterization,<sup>26</sup> once characterized as a private annuity both the annuitant and obligor are governed by the provisions applicable to private annuities.<sup>27</sup>

### FOOTNOTES

<sup>1</sup> 15 B.T.A. 1140 (1929), *aff'd on other grounds*, 42 F.2d 186 (2d Cir. 1930).

<sup>2</sup> E.g., *Garvey, Inc. v. U.S.*, 726 F.2d 1569 (Fed. Cir.), *cert. denied*, 469 U.S. 823 (1984). See generally 6 Harl, *Agricultural Law* § 49.04[1] (1992).

<sup>3</sup> 92-1 U.S. Tax Cas. ¶ 50,186 (Cls. Ct. 1992).

<sup>4</sup> I.R.C. § 483

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- <sup>5</sup> *Rye v. U. S.*, *supra* N. 3.  
<sup>6</sup> See 6 Harl, *supra* N. 2, § 49.03.  
<sup>7</sup> Pub. L. No. 96-471, 94 Stat. 2247 (1980).  
<sup>8</sup> See I.R.C. § 72.  
<sup>9</sup> See, e.g., Rev. Rul. 69-74, 1969-1 C.B. 43.  
<sup>10</sup> *Id.*  
<sup>11</sup> See Ns. 1-2 *supra*.  
<sup>12</sup> See N. 7 *supra*.  
<sup>13</sup> I.R.C. § 453(b)(1).  
<sup>14</sup> Sen. Rep. No. 96-1000, 96th Cong., 2d Sess. 23 (1980), reprinted in 1980-2 C.B. 494, 506.  
<sup>15</sup> *Id.*  
<sup>16</sup> *Id.*  
<sup>17</sup> *Id.*, 12.
- <sup>18</sup> See N. 3 *supra*.  
<sup>19</sup> 726 F.2d 1569 (Fed. Cir.), *cert. denied*, 469 U.S. 823 (1984).  
<sup>20</sup> *Id.*  
<sup>21</sup> See *Bell v. Comm'r*, 76 T.C. 232, 237 (1981), *aff'd*, 668 F.2d 448 (8th Cir. 1982).  
<sup>22</sup> *Garvey, Inc. v. U.S.*, see N. 2 *supra*.  
<sup>23</sup> See 6 Harl, *supra* N. 2, § 49.01.  
<sup>24</sup> See 6 Harl, *supra* N. 2, § 48.03.  
<sup>25</sup> See 6 Harl, *supra* N. 2, § 48.03[3][d].  
<sup>26</sup> Rev. Rul. 86-72, 1986-1 C.B. 253.  
<sup>27</sup> See Rev. Rul. 69-74, 1969-1 C.B. 43; Rev. Rul. 55-119, 1955-1 C.B. 352.

## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

### ADVERSE POSSESSION

**PRESCRIPTIVE EASEMENT.** The plaintiffs owned two tracts of land accessible only through a private road through the defendant's farm property. The plaintiffs purchased the property in 1972 and used the property for their residence and for rental of another house on the property. The defendant claimed to have granted permission to the plaintiffs and their tenants to use the road and to have erected and locked a gate on the road in 1982 in order to prevent acquisition of the road by adverse possession over ten years. The court held that the erection of the gate and the defendant's other testimony demonstrated that the defendant was aware of the plaintiffs' adverse use of the road. The trial court did not believe the defendant's testimony that permission was granted to the plaintiffs to use the road, and the appellate court did not disagree with the finding. The court also held that the construction of a new house did not change the character of the plaintiffs' use of the road as access to their residence. The court upheld the trial court order giving the plaintiffs a prescriptive easement over the road as access to the residential properties. **Gault v. Bahm, 826 S.W.2d 875 (Mo. Ct. App. 1992).**

### ANIMALS

**HORSES.** The plaintiff sued the defendant for injuries suffered when the plaintiff's automobile struck the defendant's horse on a road within 100 feet of the city limits of Tuscaloosa and within the police jurisdiction of that city. The plaintiff argued that the city ordinance applied which prohibited the owners of livestock from allowing the animals to run at large. The court held the ordinance applied in this case because cities have the authority to extend the jurisdiction of their ordinance outside the city limits, up to the police jurisdiction allowed by statute. **Wilkins v. Johnson, 595 So.2d 466 (Ala. 1992).**

### BANKRUPTCY

#### GENERAL

**AVOIDABLE LIENS.** The Chapter 7 debtors sought to avoid the unsecured portion of a lien against their homestead. The court applied *Dewsnup v. Timm, 112 S.Ct. 773 (1992)*, retroactively and held that liens could not be split into unsecured and secured portions, with the unsecured portion avoided under Section 506(d). **In re Jablonski, 139 B.R. 150 (Bankr. W.D. Pa. 1992).**

The Chapter 13 debtor sought to have an IRS lien declared unsecured as to the amount which exceeded the value of the debtor's property securing the lien. The IRS argued that *Dewsnup v. Timm, 112 S.Ct. 773 (1992)* prevented bifurcation of the lien. The court held that the *Dewsnup* holding was limited to Chapter 7 cases and allowed the avoidance of the unsecured portion of the tax lien. **In re Butler, 139 B.R. 258 (Bankr. E.D. Okla. 1992).**

**AVOIDABLE TRANSFERS.** The debtor's Chapter 12 case was converted to Chapter 7 because of fraud by the debtor in the case. The Chapter 7 trustee sought to use collateral estoppel in avoiding transfers by the debtor as fraudulent transfers. The court held that collateral estoppel would not be applied because the previous finding of fraud was more broad and did not specifically pertain to the transfers sought to be avoided in the Chapter 7 case. **In re Graven, 138 B.R. 587 (Bankr. W.D. Mo. 1992).**

**DISCHARGE.** The creditors had obtained a state court judgment against the debtor for the debtor's wrongful taking of money from a joint bank account of a decedent of whom the creditors were heirs. The creditors argued that the judgment amount was nondischargeable under Section 523(a)(4) for defalcation while the debtor was in a fiduciary capacity. The court held that Section 523(a)(4) did not apply because the debtor was found, in the state action, to have taken the money before the debtor was appointed estate representative. **In re Brawn, 138 B.R. 327 (Bankr. D. Me. 1992).**