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Stern v. Commissioner: Classification of the Private Annuity Transaction

I. INTRODUCTION

In recent years, the private annuity\(^1\) has become a much discussed tax-planning device.\(^2\) The many tax and non-tax advantages of a private annuity make it a very attractive vehicle for financial planning.\(^3\) Determining the appropriate tax classification of the private annuity transaction is important in implementing its successful use. A transfer of property in return for periodic payments may be classified as either a sale in consideration for an annuity ("sale") or a transfer in trust with income reserved ("transfer in trust").\(^4\) The two possible classifications produce very different tax consequences;\(^5\) thus, the uncertainty of tax classification increases the risks associated with the private annuity.

Recently, however, the Ninth Circuit Court of Appeals enhanced the attractiveness of the private annuity by holding on the taxpayer's side of the classification issue.\(^6\) In so holding, the court narrowed the previously followed analysis of the private annuity transaction\(^7\) and elevated the form of the transaction over its substance.\(^8\)

After a brief discussion of the tax consequences of the different classifications of a private annuity transaction, this note will review the judicial history of classification of such transactions. Next, this note will discuss the Ninth Circuit's treatment of the private annuity in Stern v. Commissioner\(^9\) and criticize the court's analysis and holding. This note will conclude by suggesting an alternative ap-

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1. See infra notes 10-18 and accompanying text.
3. See infra notes 22-69 and accompanying text.
5. See infra notes 29-69 and accompanying text.
7. See LaFargue v. Commissioner, 689 F.2d 845 (9th Cir. 1982); Lazarus v. Commissioner, 513 F.2d 824 (9th Cir. 1975); Samuel v. Commissioner, 306 F.2d 682 (1st Cir. 1962); Bixby v. Commissioner, 58 T.C. 757 (1972).
9. 747 F.2d 555 (9th Cir. 1984), rev'g 77 T.C. 614 (1981).
II. BACKGROUND

In an annuity transaction, one party, the annuitant, transfers cash or other property to another, the payor, in return for the payor's promise to make periodic payments. The amounts of the payments usually are based on the annuitant's life expectancy and the value of the property transferred. The payments are at specific intervals for life or for some stated period of time. There are several types of annuities including life annuities, temporary life annuities, joint and survivorship annuities, and annuities with refund features.

A private annuity is simply an annuity paid by an individual or company which normally does not pay annuities. The private annuity arrangement generally involves related taxpayers, such as a parent transferring property to a child in return for the child's promise to make periodic payments.

A transfer of property in exchange for periodic payments may be classified for tax purposes as either a sale or a transfer in trust.
There is, in theory, a clear difference between a sale, in which the taxpayer transfers property outright in exchange for periodic payments, and a transfer in trust, in which the taxpayer transfers property subject to the right to receive the income from that property. Nevertheless, the many similarities between the sale and the transfer in trust frequently generate disputes between the Internal Revenue Service (the "IRS") and taxpayers regarding the proper classification of particular transactions.

A. The Differing Tax Treatments of the Sale and Transfer in Trust

The annuitant-transferor achieves several tax and non-tax benefits from a sale in consideration for a private annuity. The seller-annuitant secures a steady flow of funds for the remainder of his life while being relieved of the burden of managing the transferred assets. Moreover, the child of the seller-annuitant can acquire immediate title to the assets on a deferred payment basis if the child is the buyer-payor. The more tangible benefits of the properly structured sale in consideration for a private annuity, however, come in the form of reduced income, gift and estate taxes. The transferor loses these tax benefits if the IRS succeeds in classifying the transaction as a transfer in trust with the right to income reserved.

1. Income Tax Consequences

Pursuant to section 72 of the Internal Revenue Code (the
an annuity payment is divided into a capital portion and an annuity portion. The capital portion is further divided into tax-free return of basis and taxable capital gain.

The return of basis is tax-free since the annuitant simply is getting back a portion of the value of the property that was transferred in exchange for the annuity, divided by the annuitant's actuarial life expectancy. Rev. Rul. 69-74, 1969-1 C.B. 43.

For example, if $10,000 is invested in an annuity and the expected return is $40,000, the exclusion ratio is 25%:

\[
\text{exclusion rate} = \frac{\text{investment in annuity contract}}{\text{expected return from annuity}} = \frac{\$10,000}{\$40,000} = 25\%
\]

If the amount of each annuity payment is $2,000, the tax-free return of basis is $500 ($2,000 x 25%).

"Investment in the [annuity] contract" is defined as the amount paid for the annuity contract, less any amounts received under the contract before the annuity starting date. I.R.C. § 72(c)(1) (West 1985). The "expected return" is equal to the annuitant's life expectancy multiplied by the amount of each annual payment. I.R.C. § 72(c)(3) (West 1985). Life expectancies are found in the tables in Treas. Reg. § 1.72-9, T.D. 6500 (1960).

The exclusion ratio applies even if the taxpayer lives beyond his life expectancy; the taxpayer can continue to exclude a portion from his income despite having recovered his initial capital investment. Treas. Reg. § 1.72-4(a)(4) (1975); D. Posin, supra note 11, at § 3.07. If a taxpayer dies early, however, he is not allowed a deduction for his unrecovered basis. Rev. Rul. 72-193, 1972-1 C.B. 58.

33. The capital gain portion of each annuity payment equals the present value of the expected return from the annuity less the annuitant’s adjusted basis in the property transferred in exchange for the annuity. Rev. Rul. 69-74, 1969-1 C.B. 43.

The present value of a sum due in a certain number of years in the future at a given interest rate is the amount which, if it were on hand today, would grow to equal the future sum. E. Brigham, Fundamentals of Financial Management 68 (3d ed. 1983). Present value factors for annuities are determined in Treas. Reg. § 20.2031-10(f) (1984). The "adjusted basis" for determining gain (or loss) from the sale or other disposition of property equals the cost of the property, I.R.C. § 1012 (West 1985), adjusted for expenditures, receipts, losses and other items properly chargeable to capital account (e.g., amortization, depreciation and obsolescence). I.R.C. §§ 1011(a), 1016 (West 1985). Life expectancy tables are found in Treas. Reg. § 1.72-9, T.D. 6500 (1960).
ferred in exchange for the annuity payments.\textsuperscript{34} The capital gain portion, on the other hand, represents the appreciation in value between the date on which the annuitant acquired the property and the date on which the property was transferred to the payor of the annuity.\textsuperscript{35} The capital gain portion generally is taxable at a rate lower than that applied to ordinary income.\textsuperscript{36}

The annuity portion of the periodic payment is calculated by subtracting the capital portion from the total payment.\textsuperscript{37} The annuity portion is taxable as ordinary income because it represents interest income.\textsuperscript{38} Thus, the taxpayer who sells property in exchange for an annuity may avoid any income tax on the return of basis and may also defer payment of taxes, both on capital gains resulting from the transfer and on ordinary interest income, until he receives the annuity payments.\textsuperscript{39}

None of these benefits are available to the taxpayer who transfers property in trust but reserves the right to receive income from that property. Under the grantor trust provisions of the Code,\textsuperscript{40} such a transferor is treated as the continuing owner of the trust property\textsuperscript{41} and thus is taxed on income from the property as if he had never transferred it.\textsuperscript{42} Since this type of transfer is regarded as a mere change in the form of the transferor's wealth,\textsuperscript{43} there is no return of basis or capital gain involved in the transaction.

The grantor trust provisions reflect Congress' concern that taxpayers were evading taxes by transferring assets to trusts while re-

\textsuperscript{34} See supra note 32.

\textsuperscript{35} See supra note 33.

\textsuperscript{36} If the property transferred in exchange for the annuity has been held for more than six months, 60\% of the net capital gain is deducted from the annuitant's gross income. I.R.C. \textsection\textsection 1202, 1222 (West 1985).

\textsuperscript{37} Rev. Rul. 69-74, 1969-1 C.B. 43, 44.

\textsuperscript{38} I.R.C. \textsection 72 (West 1985).


\textsuperscript{40} I.R.C. \textsection\textsection 671-678 (West 1985). These provisions are referred to as the grantor trust provisions because they treat the grantor of the trust as the owner of the trust corpus under certain circumstances. See infra notes 41-42, 45-48 and accompanying text.

\textsuperscript{41} See I.R.C. \textsection 677 (West 1985) ("[T]he grantor [of a trust] shall be treated as the owner . . . of a trust . . . whose income . . . is, or . . . may be . . . (1) distributed to the grantor . . . [or] (2) held or accumulated for future distribution to the grantor . . . ").

\textsuperscript{42} See I.R.C. \textsection 671 (West 1985), which provides in relevant part:

Where it is specified that the grantor [of a trust] shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor . . . those items of income, deduction, and credit against tax of the trust which are attributable to that portion of the trust.

Id.; see also Mathison, supra note 4, at 13.

\textsuperscript{43} See Mathison, supra note 4, at 14.
taining substantial dominion and control over the assets or the income therefrom. Thus, the Code treats the grantor of the trust as the continuing owner of the trust property if he has retained the power to control beneficial enjoyment of the trust corpus, the power of administration over the trust, the power to revoke the trust agreement and reacquire the trust property, or the right to have trust income distributed to him.

2. Gift Tax Consequences

The properly structured sale in exchange for an annuity also provides gift tax advantages to the transferor-annuitant. If the present value of the annuity promise is equal to or greater than the fair market value of the assets transferred, no gift tax liability will be created by the exchange. On the other hand, if the present value of the annuity promise is less than the fair market value of the assets transferred, a taxable gift may result to the extent of the


45. I.R.C. § 674 (West 1985) ("The grantor [of a trust] shall be treated as the owner of a trust [if] the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition . . . without the approval or consent of any adverse party.").

46. I.R.C. § 675 (West 1985). Section 675 provides in relevant part:

The grantor shall be treated as the owner of any portion of a trust in respect of which—

(1) A power . . . enables the grantor to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration . . .

(2) A power . . . enables the grantor to borrow the corpus or income . . . without adequate interest or without adequate security . . .

(3) The grantor has . . . borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year . . .

(4) A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity.

47. I.R.C. § 676 (West 1985) ("The grantor [of a trust] shall be treated as the owner of a trust . . . where at any time the power to revest in the grantor title . . . is exercisable by the grantor or a non-adverse party or both.").

48. I.R.C. § 677 (West 1985); see supra note 41.

49. See supra note 33.

50. Sections 2501-2524 of the Code are the general provisions controlling the gift tax. The gift tax is a tax imposed on the transfer of property by gift by an individual. I.R.C. § 2501 (West 1985).

51. I.R.C. § 2512(b) (West 1985).
disparity. The transferor also will incur gift tax liability if the annuity payments are payable to someone other than the transferor, or if the actuarial life expectancy used in determining the annuity payments is deemed excessive.

Although the transferor of assets in trust with income reserved continues to be treated as the owner of the assets under the grantor trust provisions, a taxable gift nevertheless will result to the extent that the value of the assets transferred exceeds the value of the interest retained by the transferor. Thus, a gift to the remaindermen of the trust will result whenever the present value of the periodic payments that the transferor will receive is less than the value of the assets transferred.

3. Estate Tax Consequences

A carefully structured sale will not create any estate tax liability. Once assets are transferred to the annuity payor, they cease to be part of the transferor's gross estate. Thus, if the terms of the annuity do not include a refund or survivorship feature and if the annuity payments terminate upon the death of the annuitant, no amount of the annuity will be included in the annuitant's gross estate. Even if the sale is shown to have been made in con-

54. See supra notes 32-33.
55. See supra notes 32-33.
56. Estate of Lion v. Commissioner, 438 F.2d 56, 60 (4th Cir.), cert. denied, 404 U.S. 870 (1971); Estate of Butler v. Commissioner, 18 T.C. 914, 919 (1952); cf. Continental Ill. Nat'l Bank & Trust Co. v. United States, 504 F.2d 586, 590-91 (7th Cir. 1974); Rev. Rul. 80-80, 1980-1 C.B. 194; Rev. Rul. 66-307, 1966-2 C.B. 429; Zaritsky, supra note 22, at 368 (requiring the annuitant's actual life expectancy to be used if the annuitant is terminally ill; the life expectancy tables, see supra notes 32-33, are inapplicable).
57. I.R.C. § 677 (West 1985); see supra notes 41, 48 and accompanying text.
59. See supra note 33.
60. See Treas. Reg. §§ 25.2512-5(b), (d), (f) (1984), 25.2512-9(b), (d), (f) (1984); Mathison, supra note 4, at 15.
61. Sections 2001-2210 of the Code are the general provisions for the estate tax. The estate tax is "a tax imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States." I.R.C. § 2001 (West 1985).
62. See Mathison, supra note 4, at 16; Zaritsky, supra note 22, at 369.
63. See supra note 16.
64. See supra note 15.
65. See supra notes 13, 15.
66. See I.R.C. § 2039 (West 1985); Treas. Reg. § 20.2039-1 (1976). The value of a decedent's gross estate is determined by including the value at the time of his death of all
temption of death, no estate tax liability will follow if the value of the property transferred equals the value of the annuity promise received.67

On the other hand, the Code includes in a decedent's gross estate the value of any property which the decedent during his lifetime transferred for less than full and adequate consideration if he retained a right to the lifetime possession or enjoyment of the property or retained the right to designate who should receive possession or enjoyment of the property and income therefrom.68 Thus, if a transaction is classified as a transfer in trust with income reserved, the assets transferred will be included in the gross estate of the transferor and will be subject to estate taxes.69

B. Reclassification in the Courts

The tax consequences of classifying a particular transaction as a sale in exchange for an annuity or a transfer in trust with income reserved demonstrate the importance of determining the category in which a particular transaction belongs. A determination of the appropriate classification may be difficult, however, because the difference between a sale and a transfer in trust, in form, sometimes is so slight that even minimal modification of the purported annuity agreement may lead to unexpected and unwanted results.70 Therefore, in order to secure the tax benefits of a private annuity, a transferor-annuitant must meticulously structure the annuity transaction or risk a complete reversal of the tax consequences he

property, real or personal, tangible or intangible, wherever situated. I.R.C. § 2031(a) (West 1985); see also infra note 67.

If the terms of the annuity provide a refund or survivorship feature, or if the payments were to continue for a period which did not in fact end before the annuitant's death, then the decedent's gross estate will include the value of the survivor's annuity corresponding to the proportionate share of the purchase price contributed by the decedent. I.R.C. § 2039(a), (b) (West 1985). Under § 2056, if this amount is paid to a surviving spouse, it will qualify for the estate tax marital deduction, which allows a surviving spouse to deduct from the value of the gross estate an amount equal to the value of the property passing from the decedent to the surviving spouse. I.R.C. § 2056 (West 1985).

67. Under § 2035 of the Code, a decedent's gross estate, see supra note 66, includes property which the decedent transferred, to a trust or otherwise, during the three-year period preceding his death, I.R.C. § 2035(a) (West 1985), unless the transfer was a bona fide sale for adequate and full consideration. I.R.C. § 2035(b)(1) (West 1985).

If property transferred in exchange for an annuity exceeds in value the annuity promise, the difference can be taxed as a gift made in contemplation of death if the transaction was completed within three years prior to death. Croft & Hipple, supra note 53, at 262-63.

68. I.R.C. § 2036 (West 1985).

69. See id.; Mathison, supra note 4, at 15.

70. Croft & Hipple, supra note 53, at 260-61.
seeks to obtain.71

Cases in which the IRS has challenged private annuity transac-
tions illustrate the difficulty of classifying these arrangements. The
decisions have not been consistent in their rationales or in their
holdings. Instead, each court of appeals opinion seems to offer a
different test for classification of such transactions.

1. Samuel v. Commissioner

In Samuel v. Commissioner,72 the taxpayer transferred valuable
documents, which later became known as the “Dead Sea Scrolls,”73 to a trust of which he became co-trustee.74 The original
trust agreement provided that all of the income and ninety percent
of the principal of the trust were to be disposed of at the taxpayer's
discretion, that the taxpayer would retain full power to amend and
revoke the trust, and that the trustees would have broad powers to
deal with the trust corpus.75 The trust agreement later was
amended to provide for annual payments to the taxpayer, from in-
come or principal, as determined by the trustees.76

In the first three years of the trust, no income was earned on the
trust assets77 and no distributions were made to the taxpayer.78 In
the fourth year of the trust, the scrolls were sold by the trustees
and the trust reported income, but the taxpayer still did not receive
annual payments.79 Finally, in the fifth and sixth years of the trust,
the taxpayer began to receive his annual payments.80 The IRS re-

71. See Ginsburg, supra note 23, at 578-79 (warning that “it is poor planning to have
as the buyer (issuer of the annuity contract) a trust, and particularly one established for
the benefit of anyone who is a natural object of the seller's bounty,” for the transaction is
at risk of being reclassified).
72. 306 F.2d 682 (1st Cir. 1962).
73. Id. at 683. The taxpayer, while serving in the Middle East, purchased the scrolls
for $15,000. Id.
74. Id.
75. Id. at 683-84. The trustees were granted the power to buy, hold, sell, exchange,
and lease all types of real and personal property, and to allocate to income and capital all
trust receipts and trust expenditures. Id. at 684.
76. Id. The amendment provided a $15,000 reimbursement for taxpayer's expenses
and an additional $15,000 for his expected future expenses. Id. Additionally, a $10,000
annual payment, payable from income or principal at the trustee's discretion, was to be
made to the taxpayer. Id.
77. Id. There was no income because the corpus for the trust consisted solely of the
scrolls. Id.
78. Id.
79. Id. The scrolls were sold for $250,000 and the trust reported income of
$3,794.37. Id. The taxpayer, however, received his two $15,000 payments as reimburse-
ment for expenses. Id.; see supra note 76.
80. Id. The trust in these years reported income of $8,541.75 and $10,315.31. Id.
jected the taxpayer's contention that he had sold the scrolls to the trust, and instead reclassified the transaction as a transfer in trust with income reserved.\textsuperscript{81}

The First Circuit held that while the formal documents purported to create a trust,\textsuperscript{82} the court would not hesitate to look beyond the formalities of the transaction and, where warranted, attribute to the grantor the tax consequences of a reserved enjoyment of income.\textsuperscript{83} The court stated that in the normal annuity situation, in which the annuitant has transferred property to the obligor-payor in return for a contractual right to periodic payments, the annuitant is unconcerned with the ultimate disposition of the property transferred.\textsuperscript{84} By contrast, the taxpayer in Samuel had retained effective control of the property transferred to the trust.\textsuperscript{85} The court therefore concluded that the transaction should have been classified as a transfer in trust with reserved interests.\textsuperscript{86}

The First Circuit thus developed a practical control test for determining a particular transaction's classification: a transfer of assets in exchange for periodic payments is a sale only if the purported annuitant has relinquished so many incidents of ownership that it may no longer be said that he has effective control over the property transferred; if the transferor retains effective control, the transaction is properly classified as a transfer in trust with reserved interests.\textsuperscript{87}

\begin{itemize}
  \item \textsuperscript{81} Id. at 685.
  \item \textsuperscript{82} Id.
  \item \textsuperscript{83} Id. at 688.
  \item \textsuperscript{84} Id. at 687.
  \item \textsuperscript{85} Id. The court stated that under § 677 of the Code, it is enough if the income of the trust may be held or accumulated for future distribution to the grantor. Id. at 686 (citing Helvering v. Evans, 126 F.2d 270, 272-73 (3d Cir. 1942); Greenough v. Commissioner, 74 F.2d 25, 27 (1st Cir. 1934)) (emphasis added).
  \item \textsuperscript{86} Samuel, 306 F.2d at 687.
  \item \textsuperscript{87} Id.; see also Bixby v. Commissioner, 58 T.C. 757 (1972), in which the taxpayers established several trusts, initially funded with $1,000 by a nominal settlor, and transferred stock to them in return for a lifetime annuity. Id. at 767. The trust agreement included provisions delineating the distribution of income and the power of the trustee to lend money to the beneficiaries of the trust, the taxpayers, on an unsecured, interest-free basis. Id. Further, the trust agreement established an advisory committee, directed by the taxpayers, which had plenary power over the trust assets, including the power to manage and invest the trust estate and the power to veto virtually any act of the trustee affecting the estate. Id. The agreement also limited the trustee's liability for performing any act in accordance with the direction of the advisory committee. Id.

The Bixby court found that the entire transaction was designed to allow the taxpayers to maintain control of the transferred assets and the income therefrom while they were claiming the benefits of a private annuity. Id. at 789. The court, relying on Samuel, found the taxpayers' maintenance of control over the transferred assets crucial in determining the transaction's classification, and articulated a practical test for determining the
2. *Lazarus v. Commissioner*

In *Lazarus v. Commissioner,* the Ninth Circuit and the Tax Court considered several factors other than the degree of the taxpayer's control in determining whether a transfer should be classified as a sale or a transfer in trust. In *Lazarus,* the taxpayer had established a trust, named his children and other relatives as beneficiaries and reserved in himself the right to replace the trustee. The taxpayer then entered into an annuity agreement by which he transferred stock in a shopping center to the trust in exchange for the trustee's promise to pay him $75,000 a year. Thereafter, the trustee sold the stock to a third party in exchange for a non-negotiable promissory note for $1 million with annual interest payments of $75,000. The IRS reclassified the purported annuity agreement as a transfer in trust with income reserved.

Both the Tax Court and the Ninth Circuit stressed that the taxpayer was entitled to adopt any tax plan which, by any legal means, would decrease or avoid altogether the amount of taxes he otherwise would owe. Both courts held that the substance and not the form of a transaction should determine how the transaction is treated for tax purposes and that a series of related transactions...
must be considered together and not in isolation. Examining the annuity agreement, the trust instrument, and the non-negotiable promissory note, the Tax Court found that trust characteristics clearly predominated, despite the fact that the instruments were cast in the form of a sale in exchange for an annuity.

The court based its decision upon a “totality” of several circumstances, all of which were characteristic of a transfer in trust rather than an arm’s-length sale. The taxpayer’s $75,000 annual payment was equal to the interest payments that the trust was to receive from the non-negotiable note, the trust’s only income-producing asset. Moreover, because the annual payments were to come from the note’s interest, the trust corpus would remain intact and the full $1 million principal would pass to the taxpayer’s children and other relatives, just as it would have passed had the transaction been cast as a transfer in trust with a retention of income. The initial transfer from the taxpayer to the trust did not include a down-payment, security, or interest on the deferred purchase price, although such terms are normally found in a bona fide arm’s-length sale. Finally, there was no relationship between the shopping center’s value and the purported purchase price of the annuity; normally, an arm’s-length sale is not made for a fraction of the transferred property’s value. In a transfer in trust, however, no relationship need exist between the value of the retained interest and the transferred property’s value.

95. Lazarus, 513 F.2d at 829; Lazarus, 58 T.C. at 864; see also Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613-14 (1938); Kanawha Gas & Utilities Co. v. Commissioner, 214 F.2d 685, 691 (5th Cir. 1954).
96. Lazarus, 58 T.C. at 867.
97. Id. at 867-69.
98. Id. at 867.
99. Id. at 867-68.
100. Id. at 868.
101. Id. The court noted:

Payments to annuitants are, in fact, based upon mortality tables which purport to reflect a rate of return sufficient to enable the annuitant to recover his cost and in addition thereto a low rate of return on his investment.” . . . It is well known that an annuity is calculated to yield a recipient who lives out his expectancy a total amount equal to the consideration paid, plus interest thereon. . . .

Id. at 869 (citations omitted) (quoting George H. Thornley, 2 T.C. 220, 229 (1943), rev’d on other grounds, 147 F.2d 416 (3d Cir. 1945)); see also Glenn E. Edgar v. Commissioner, 56 T.C. 717, 742-43 (1971); J. Giltner Ingehart, Sr. v. Commissioner, 10 T.C. 766, 769-70 (1948), aff’d, 174 F.2d 605 (7th Cir. 1949); Treas. Reg. § 1.72-1(c)(1) (1956).
3. LaFargue v. Commissioner

In LaFargue v. Commissioner, the Ninth Circuit continued to emphasize factors other than control in determining the proper classification of a purported annuity transaction. The taxpayer's investment plan included two steps: creation of a trust and execution of a contract under which the taxpayer exchanged stock and other assets for the trustee's promise to make annual payments. The terms of the trust agreement granted the taxpayer a limited power of appointment over the trust assets. The annuity agreement stated that no security was given for the annual payments and that no interest factor was involved. The administration of the trust was lax; the annual payments were all late, yet no penalty was assessed, and the taxpayer, not the trust, continued to receive the dividends because the transfer agent was not notified about the stock transfer.

The Tax Court concluded that the substance of the transaction was the creation of a trust which reserved to the grantor the right to annual payments. The court found it significant that without the transferred property, the trust would have been an empty shell and that this property was the only source of petitioner's payments. The court also noted that no relationship existed between the present value of the annual payments and the fair market

103. 698 F.2d 845 (9th Cir. 1982), rev'g 73 T.C. 40 (1979).
104. LaFargue, 73 T.C. at 43. Taxpayer created a trust, with nominal corpus, for her daughter's benefit. Id. at 42-43. As trustees she chose her sister, a family friend, and her attorney. Only the attorney had any experience in trust administration. Id. at 43.
105. Id. Pursuant to the agreement taxpayer transferred assets worth $335,000 in exchange for annual payments of $16,502. Id. at 43, 46-47.
106. A power of appointment is the power to select the person or persons who are to receive the corpus or income of the trust. G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 264.20, at 432 (rev. 2d ed. 1977).
107. LaFargue, 73 T.C. at 44.
108. Id. at 47. Because the annuity was calculated without an interest factor, the actuarial value of the annual payments was significantly less than the value of the property transferred. Id. at 55-56.
109. Id. at 48. For the first three years, no payments were made on time. Id. The annuity payments were due annually on June 1. In 1971, the payment was received on September 1; in 1972, on December 29; and in 1973, on July 6. Id. A late payment penalty provided for in the agreement never was assessed. Id. The dividends were not recorded by taxpayer as income on her individual returns but were instead reported on the fiduciary tax return. Id.
110. Id. at 53. The court viewed the series of related transactions as a whole and based its conclusion on the totality of the circumstances, rather than any one decisive factor. Id.
111. Id. at 53-54.
112. Id. at 54.
value of the transferred property,\footnote{113} that no interest factor was used in calculating the deferred payments,\footnote{114} and that the taxpayer viewed herself as the beneficial owner rather than as a creditor of the trust.\footnote{115}

The Ninth Circuit reversed, holding that classification as a sale was consistent with the formal structure of the transaction and an accurate reflection of its substance.\footnote{116} Noting the absence of a direct correlation between the annual payments and the trust income,\footnote{117} the court held that it could not disregard the formal structure of the transaction as a sale absent an indication that the annuity agreement was a mere disguise for transferring the income of the trust to the grantor.\footnote{118} The court concluded that since the fundamental transfer and annuity obligations of the contract had been met and the taxpayer had relinquished control over the transferred property, the transaction was a sale.\footnote{119}

\footnote{113} Id. at 54-55. The present value of the annuity payments equalled $176,990 and the fair market value of the property was $335,000. Id. This disparity is uncharacteristic of an arm's-length sale or exchange. Lazarus v. Commissioner, 58 T.C. 854, 868 (1972), aff'd, 513 F.2d 824 (9th Cir. 1975).

\footnote{114} LaFargue, 73 T.C. at 55. This is also uncharacteristic of a sale in exchange for an annuity agreement. Id.; see also Lazarus v. Commissioner, 58 T.C. 854, 869 (1972), aff'd, 513 F.2d 824 (9th Cir. 1975).

\footnote{115} LaFargue, 73 T.C. at 56-57. The court based this finding on the manner in which the property was administered, which included the taxpayer's continued receipt of the dividends from the transferred stock, her failure to assess the penalty for late payments, and her right to be included at meetings held to discuss the administration of the trust. Id.

\footnote{116} LaFargue, 689 F.2d at 846-47.

\footnote{117} Id.; see supra note 98 and accompanying text. The Ninth Circuit distinguished Lazarus, see supra notes 88-102 and accompanying text, on the grounds that its rationale simply could not apply to this annuity arrangement since the fixed annuity payments were not a conduit for the income of the trust. LaFargue, 689 F.2d at 848. “The payment simply did not represent a camouflaged transfer of trust income.” Id. at 849. The court did find that here, as in Lazarus, the property transferred constituted the bulk of the trust assets. Id. However, in LaFargue the trust corpus was assessable for payment of the annuity while in Lazarus the corpus was not assessable. Id. (citing Lazarus v. Commissioner, 513 F.2d 824, 829 (9th Cir. 1975); Lazarus v. Commissioner, 58 T.C. 834, 870-71 (1972)).

\footnote{118} LaFargue, 689 F.2d at 846-47. The court noted, “Had [the grantor] taken an active role in trust investment decisions or held some power to manage the trust or control the trustees, we might apply the rationale of Bixby v. Commissioner, 58 T.C. 757 (1972), or Samuel v. Commissioner, 306 F.2d 682 (1st Cir. 1962).” Id.; see supra notes 72-87 and accompanying text.

\footnote{119} LaFargue, 689 F.2d at 848-49. For Tax Court decisions which in essence have followed LaFargue while stating no opinion as to its validity, see Estate of Fabric v. Commissioner, 83 T.C. 932 (1984); Benson v. Commissioner, 80 T.C. 789 (1983).
III. STERN V. COMMISSIONER

A. Facts

In Stern v. Commissioner,120 the Ninth Circuit again considered whether a complex annuity transaction should have been reclassified. Seeking certain tax benefits,121 taxpayers Sidney and Vera Stern decided to transfer stock to a foreign situs trust in exchange for a private annuity.122 The Sterns instituted their plan by having an acquaintance act as settlor to establish an irrevocable trust for the benefit of the Sterns and their children.123 Although the settlor contributed funds to the trust, the overwhelming majority of the value of the trust was contributed by the Sterns.124

The trust agreement authorized the trustee to lend money to the beneficiaries, the Sterns and their children, on an unsecured, interest-free basis, and to distribute trust income or corpus to them.125 The taxpayers retained a power of appointment over the trust fund126 and the power to remove the trustee without cause.127 The annuity agreement required the trust to make annual payments128 regardless of the value of the property held and the amount of income produced.129 The trustee's liability, however, was limited to the value of the trust assets; once these assets were exhausted, the trustee was no longer obligated to make further payments.130

Sidney Stern made several suggestions regarding the investment decisions of the trust.131 The trustee approved one such suggestion and invested $25,000 in a company which was to be owned and

120. 747 F.2d 555 (9th Cir. 1984), rev'g 77 T.C. 614 (1981).
121. See supra notes 29-69 and accompanying text.
122. Stern, 77 T.C. at 616.
123. Id. at 617-18.
124. Id. at 617-18, 621. The settlor and his law firm invested $5,100 (expecting to generate future business for the firm), while the Sterns contributed approximately $2,950,000 (this equals the number of shares of stock they transferred, multiplied by the value of the stock on the day of the transfer). Id.
125. Stern, 77 T.C. at 620.
126. Id. at 619. The power of appointment was limited by the trust agreement in that it could not be exercised in favor of the donee, his estate, his creditors, or the creditors of his estate. Id. at 619 n.9.
127. Id. at 619. The trust agreement required the successor trustee to be a company empowered to administer trusts and having authorized capital of at least $100,000 in Bahamian currency. Id. at 619 n.10.
128. Id. at 622. The annuity payments were $222,757.01 and $27,216.85 to Sidney and Vera respectively. Id. at 621. These figures were obtained by dividing the fair market value of the stock transferred by the appropriate annuity factor found in Estate Tax Treas. Reg. § 20.2031-10(f) (1984). Stern, 77 T.C. at 621-22.
129. Stern, 77 T.C. at 622.
130. Id.
131. Id. at 632-33.
operated by Mr. Stern. In connection with this investment, Sidney Stern applied for a broker's license, which required the filing of a personal financial statement. On this statement Mr. Stern included among his personal assets stock previously transferred to the trust, but he made no mention of any annuity.

Mr. Stern also selected a new investment company to advise the trustee. When this investment company decided to sell all the stock originally transferred to the trust, it obtained an attorney's opinion letter regarding the ramifications of such a sale under the securities laws. This letter indicated Sidney Stern's and the trustee's belief that Mr. Stern, and not the trust, owned the stock. Mr. Stern later terminated the investment company's services after it failed to follow his advice. Further, when Mr. Stern became displeased with the trustee's reporting, documentation and fees, he removed the trustee and substituted another.

B. The Tax Court

The Tax Court upheld the IRS's reclassification of the Stern's transactions as a transfer in trust with income reserved. The court stated that in classifying a particular transaction, a delicate balance exists between the taxpayer's right to arrange his affairs to minimize his taxes and the requirement that a transaction's substance rather than its form must control its tax consequences. The court considered several factors in rejecting the Stern's contention that they had sold assets in exchange for an annuity contract.

The court found that the trust's creation and the annuity agreement were integral parts of a prearranged plan, neither of which

132. Id. at 625-28.
133. Id. at 626.
134. Id.
135. Id. at 630-32. The taxpayer interviewed Stephen Weiss, of Weiss, Peck & Greer, questioned him extensively about his firm's qualifications to manage the trust, and thereafter sent a letter indicating his approval of Weiss, Peck & Greer as the investment advisor. Id.
136. Id. at 632.
137. Id. The letter stated, "You have been assured by Mr. Stern and [the trustee]... that neither... has sold or attempted to sell any of the shares... connect[ed] with this acquisition." Id.
138. Id. at 632-34. The concerns he expressed included the desire to preserve the trust corpus while producing sufficient income to service his annuities. Id. at 632-33.
139. Id. at 634.
140. Id. at 640.
141. Id. at 639.
would have been executed without the other.  It concluded that the economic results of the transactions, including transfer of the remainder of the trust to the natural objects of the taxpayers' bounty, could have been achieved through a transfer with a reserved right to payments equal to the calculated annuity amounts rather than by selling the property to the trust. The court also noted that the assets transferred by the Sterms to the trust and the income derived therefrom were the only sources of funds for the annual payments.

The court stated that the trust terms giving Mr. Stern the indicia of ownership demonstrated that he had retained an interest in the transferred assets. According to the court, the Sterms were assured of receiving the value of any appreciation, because they were the beneficiaries of the trust, they had a power of appointment enabling them to dispose of trust corpus, and they had the power to remove the trustee without cause. The court found that the Sterms had participated in the trust investment decisions and had claimed to be the owners of the trust property when it benefited them. Finally, the court noted that the attorney's opinion letter, which stated that Sidney Stern had not sold any of the stock, indicated that Mr. Stern viewed himself as a beneficial owner rather than as a creditor of the trust property. The court concluded that an overall consideration of these factors, no one of which was controlling, supported reclassification of the annuity transaction as a transfer in trust with income reserved.

C. The Court of Appeals

A divided panel of the Ninth Circuit reversed, concluding that this case was "on the taxpayer's side of the line" because the transaction lacked a connection between the amount of the annuity and the trust income, and because the Sterms did not possess the degree of control necessary for the court to disregard the formal structure

\[142\] Id. at 640-41. "[T]he consideration exchanged for the 'annuities' constituted the corpa of the newly created trusts." Id. at 641.

\[143\] Id. at 641.

\[144\] Id. at 641-43. "[T]he nexus between the payments and the transferred properties creates in the transferor a continuing interest in those properties. This is uncharacteristic of a sale and annuity arrangement wherein the annuitant generally assumes the role of a creditor."

\[145\] Id. at 642.

\[146\] Id. at 642-43.

\[147\] Id. at 643-44.

\[148\] Id. at 645.

\[149\] Id. at 645-46.
of the transaction and reclassify it as a transfer in trust with income reserved. The court pointed out that under the provisions of the trust, it was the trustee, not the taxpayers, who controlled the investment of the trust assets. Although Mr. Stern gave his advice, it was rarely followed, and when it was followed, it involved only an insignificant investment amount. The court held that these minor informalities did not justify disregarding the formal structure of the transaction "because the fundamental transfer and annuity obligations were being met and the taxpayer had relinquished control over the property transferred."

D. The Dissent

The dissenting judge believed that the majority had elevated the form of the transaction over its substance and that the Sterns possessed control and beneficial enjoyment sufficient to support reclassification. The dissenter's conclusion that the Sterns retained sufficient control was based on several factors. The dissent noted that the Sterns has the power to remove the trustee without cause and to appoint a new one, that Mr. Stern continued to give advice and make proposals which were followed by the trustee, and that Mr. Stern selected and later terminated the trust's investment company.

The dissent also stated that the Sterns faced none of the risks normally borne by annuitants. For example, the risk of early death, usually present in an annuity, was not present since the residue of the trust was held for the benefit of the Sterns and their heirs; the Sterns had nothing to lose. Thus, according to the dissent, it made little difference to the Sterns whether the accumulated value of their annuity payments approximated the fair market value of the stock transferred.

150. Stern, 747 F.2d at 558, 560.
151. Id. at 559.
152. Id. The investment totaled only $25,000 while the assets of the trusts were over $4.3 million. Id. at 559 n.8.
153. Id. at 560.
154. Id. at 561 (Enright, J., dissenting).
155. Id. at 561-63.
156. Id. at 562.
157. Id. at 561.
158. Id.
159. Id.
161. Stern, 747 F.2d at 562-63 (Enright, J., dissenting).
162. Id.
the Sterns would be classified more appropriately as beneficial owners than as seller-annuitants.\textsuperscript{163}

IV. Analysis

Courts have relied upon several factors in deciding cases in which the taxpayer asserts that an annuity transaction is a sale in exchange for an annuity while the IRS asserts that the transaction is a transfer in trust with income reserved. The decisions all stress that these factors are to be considered as a whole; no factor alone is to be decisive.\textsuperscript{164} Courts have considered the following factors important: the relationship between the creation of the trust and the property transferred to it,\textsuperscript{165} the similarity between the amount of income generated by the transferred property and the amount of annuity payments,\textsuperscript{166} the source of the annuity payments,\textsuperscript{167} the degree of the annuitant's control over the transferred property,\textsuperscript{168} the nature and extent of the annuitant's continuing interest in the transferred properties,\textsuperscript{169} and the arm's-length nature of the annuity arrangement.\textsuperscript{170}

Beginning with \textit{LaFargue}, however, courts began limiting the range of determinative factors.\textsuperscript{171} In \textit{Stern}, the Ninth Circuit restricted these factors even further. The court's rationale focused on the formal documents, the lack of a tie-in between the trust income and the annual payments, and the degree of control the Sterns were held to possess. In determining the impact of these factors, the Court overemphasized the form of the transactions and underemphasized their substance. The decision appears to sanc-

\textsuperscript{163} \textit{Id.}


\textsuperscript{165} \textit{LaFargue v. Commissioner}, 73 T.C. 40, 53-54 (1979), rev'd, 689 F.2d 845 (9th Cir. 1982); \textit{Lazarus v. Commissioner}, 58 T.C. 854, 866 (1972), \textit{aff'd}, 513 F.2d 824 (9th Cir. 1975).

\textsuperscript{166} \textit{Lazarus v. Commissioner}, 58 T.C. 854, 867-68 (1972), \textit{aff'd}, 513 F.2d 824 (9th Cir. 1975).

\textsuperscript{167} \textit{Id.} at 868.

\textsuperscript{168} \textit{Samuel v. Commissioner}, 306 F.2d 682, 687 (1st Cir. 1962); \textit{Bixby v. Commissioner}, 58 T.C. 757, 789-90 (1972).

\textsuperscript{169} \textit{LaFargue v. Commissioner}, 73 T.C. 40, 54 (1979), rev'd, 689 F.2d 845 (9th Cir. 1982); \textit{Lazarus v. Commissioner}, 58 T.C. 854, 866 (1972), \textit{aff'd}, 513 F.2d 824 (9th Cir. 1975).

\textsuperscript{170} \textit{Lazarus v. Commissioner}, 58 T.C. 854, 868-69 (1972), \textit{aff'd}, 513 F.2d 824 (9th Cir. 1975).

\textsuperscript{171} \textit{See supra} notes 116-19 and accompanying text.
tion a method of improper tax avoidance. The court thus ignored the Supreme Court's warning that an examination of the facts, in light of economic realities, should not be frustrated by overemphasizing "technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct." The Ninth Circuit agreed with the Tax Court's finding that there was no tie between the annuity payments and the trust income. The court of appeals acknowledged, however, that the absence of a connection is not conclusive. The presence of a tie-in may justify the classification of the transaction as a transfer in trust, but in the absence of a tie-in, further analysis is needed. LaFargue suggests that if a taxpayer has the ability to control the trust assets or the trustee, a court may reclassify an apparent sale as a transfer in trust.

The Stern court concluded that the Sterns did not retain a degree of control sufficient to justify reclassifying the transaction. The court held that the trust provisions granted the trustee, not the taxpayers, control over the trust assets. The trustee's control, however, was merely "on paper." The Sterns' power to remove the trustee without cause gave them the real control. If the trustee refused to follow their wishes, they could replace him with someone who would. The power to replace a trustee without cause has been held tantamount to possessing the powers of the trustee and thus control of the trust. When one combines the unlimited power to replace the trustee with the Sterns' investment advice, the trustee's limited ability and its authority to lend money to the

174. Stern v. Commissioner, 747 F.2d 555, 558 (9th Cir. 1984); 77 T.C. 614, 641-42 n.49.
175. Stern v. Commissioner, 747 F.2d 555, 558 (9th Cir. 1984) (citing LaFargue v. Commissioner, 689 F.2d 845, 847 (9th Cir. 1982)).
176. Stern v. Commissioner, 747 F.2d 555, 558 (9th Cir. 1984) (citing LaFargue v. Commissioner, 689 F.2d 845, 847 (9th Cir. 1982)).
177. LaFargue v. Commissioner, 689 F.2d 845, 849 (9th Cir. 1982).
178. Stern v. Commissioner, 747 F.2d 555, 559 (9th Cir. 1984).
179. Id.
181. Id. (the trustee is likely to be predisposed to follow the wishes of the holder of such a power, for if he does not, the holder of the power can remove him and appoint another trustee); see also Van Beuren v. McLoughlin, 262 F.2d 315, 318 (1st Cir. 1958), cert. denied, 359 U.S. 991 (1959); Rev. Rul. 79-353, 1979-2 C.B. 325.
Sterns on an unsecured and interest-free basis, the Sterns’ absolute control over the trust corpus becomes apparent.

In holding that the Sterns did not retain sufficient control to justify recategorization, the court gave too little weight to the fact that the trustee followed Mr. Stern’s advice and invested $25,000 into a financial company which was to be owned and operated by Mr. Stern.\(^{182}\) The court found the amount of the investment insignificant.\(^{183}\) This transaction was important, however, not because of the amount involved but because it demonstrated that the trustee would follow Mr. Stern’s advice. In fact, the trustee later followed his advice in much more significant transactions—the selection and eventual termination of investment counsel for the trust.\(^{184}\) It was more than mere coincidence that the trustee took advice so willingly; Mr. Stern merely was exercising the control that he had in fact retained.

The Ninth Circuit also held that the Sterns had relinquished control over the property transferred despite certain informalities in the trust administration.\(^{185}\) These informalities included Mr. Stern’s listing the transferred common stock among his personal assets and the attorney’s letter stating that Mr. Stern had not sold any of the stock.\(^{186}\) While these statements alone may not have been conclusive, they became damaging admissions when considered along with the other indicia of the Sterns’ retention of control.

The taxpayers transferred control of their assets on paper, but their overall economic situation in fact had not changed. The Sterns could have used the assets after the transfer as before, had they wanted or needed them. The Sterns had the power to make sure that their desires would be followed by choosing a trustee who would act in accordance with their wishes.\(^{187}\) The trustee could, at the Sterns’ request, lend them money on an unsecured, interest-free basis.\(^{188}\) The taxpayers’ money was “secure” because the Sterns and their children were the beneficiaries of the trust.\(^{189}\) They could take the money now or later when they wanted or needed it because as beneficiaries all the money would inure to them anyway.

\(^{182}\) Stern v. Commissioner, 747 F.2d 555, 559 & n.8 (9th Cir. 1984).

\(^{183}\) Id.

\(^{184}\) Id. at 561.

\(^{185}\) Id. at 560.

\(^{186}\) Id.

\(^{187}\) See supra notes 180-81 and accompanying text.


\(^{189}\) Id. at 615.
Further, it did not matter that the value of the payments was not equal to the value of the transferred property because, as beneficial owners of the trust, the Sterns in effect were selling to themselves.

The Ninth Circuit's analysis in *Stern*, by limiting the factors considered and stressing the form of the transaction over its substance, will lead to unwarranted and unexpected results which Congress attempted to avoid when it enacted the grantor trust provisions. The *Stern* decision makes it easy to circumvent the congressional desire to prevent evasion of taxes through trusts which effectively distribute their income for the use or benefit of the grantor. The holding permits exactly what Congress was trying to prevent: a grantor retaining practical control over assets transferred to a trust while reaping the advantageous tax consequences of classifying the transaction as a sale in exchange for an annuity.

The *Stern* holding sends out the wrong signal to those who possess the means to circumvent their tax responsibilities. A taxpayer who wants the tax benefits of a sale along with the control of a transfer in trust with income reserved can achieve both under the *Stern* rationale. Those taxpayers who can afford to hire a clever tax planner can have their private annuity transaction clothed with all of the formal indicia of a sale, and, while not outwardly showing control, can make sure that they will be able to control the assets through indirect mechanisms. When Congress enacted the grantor provisions of the Code, it sought to prevent exactly this type of "form-over-substance" manipulation.

V. ALTERNATIVE

When determining the proper classification of a transfer in exchange for periodic payments, the courts should start with an examination of the formal documents. If the provisions of the trust agreement expressly give the taxpayer reversionary interests, the power to control the beneficial enjoyment of the trust corpus or

190. Id. at 617-18, 621; see supra note 124 and accompanying text.
191. See supra note 44 and accompanying text.
192. Id.
194. See supra notes 29-69 and accompanying text.
195. See supra notes 40-48 and accompanying text.
196. See supra notes 40-41, 45-48 and accompanying text.
197. See Kaplan v. Commissioner, 66 F.2d 401, 402 (1st Cir. 1933); supra note 44 and accompanying text.
income,\(^{199}\) administrative powers,\(^{200}\) or the power to revoke the trust,\(^{201}\) then the transaction should be classified as a transfer in trust with reserved income. Under the grantor trust provisions, a grantor who retains these interests or powers is taxed as if he had never relinquished ownership of the trust assets.\(^{202}\) Given the importance of retention of control in the determination of whether a "sale" has occurred,\(^{203}\) courts should be guided by the grantor trust provisions in deciding classification cases.

If the formal documents do not, by their terms, give the taxpayer reversionary interests or powers of control, the courts should then analyze the substance of the documents' provisions in a manner which recognizes their true economic reality.\(^{204}\) The relationship between the trust income and the amount of the periodic payments may be determinative.\(^{205}\) If a direct correlation exists between trust income and the amount of the periodic payments, then the "annuity" arrangement is nothing more than a conduit for the trust income and the transaction should be classified as a transfer in trust with income reserved.\(^{206}\)

If no such correlation exists, the courts should consider whether the taxpayer can control the trust corpus or the actions of the trustee.\(^{207}\) The courts should analyze whether the taxpayer retained an interest in the trust (other than as a direct creditor),\(^{208}\) whether the transaction was at arm's length,\(^{209}\) and whether the trust has any substance beyond the property which the taxpayer transferred to it.\(^{210}\) If analysis of all these factors leads to the conclusion that the taxpayer is "disinterested," then, and only then, should the transaction be classified as a sale and the taxpayer allowed to reap the concomitant tax benefits.

\(^{199}\) See I.R.C. § 674 (West 1985); supra note 45.
\(^{200}\) See I.R.C. § 675 (West 1985); supra note 46.
\(^{201}\) See I.R.C. § 676 (West 1985); supra note 47.
\(^{202}\) See supra notes 40-43, 45-47 and accompanying text.
\(^{203}\) See supra notes 168, 177-81 and accompanying text.
\(^{206}\) See Lazarus v. Commissioner, 58 T.C. 854, 867 (1972), aff'd, 513 F.2d 824 (9th Cir. 1975).
\(^{207}\) See supra note 168 and accompanying text.
\(^{208}\) See supra note 169 and accompanying text.
\(^{209}\) See supra note 170 and accompanying text.
\(^{210}\) See supra notes 111-12 and accompanying text.
VI. CONCLUSION

The courts are faced with a difficult task when they are asked to reclassify a private annuity transaction. They must contend with taxpayers asserting their rights to arrange their affairs in any legal manner they desire and with the IRS asserting that the taxpayers have not, through their transactions, changed their economic situations enough to justify different tax treatment. The *Stern* court tilted the scale towards the taxpayer by considering only a narrow range of factors and by emphasizing form over substance. The court allowed taxpayers to obtain all of the benefits of a sale without the tax burdens of a transfer in trust with income reserved. Such an outcome runs contrary to the congressional desire, codified in the grantor provisions of the Code, to prevent a taxpayer from evading taxes by transferring assets to a trust whose corpus and income is really at the disposal of the taxpayer.

The courts should reject *Stern* in favor of an analysis which first examines whether the “annuity” agreement is a mere vehicle for transferring the income of the trust. If the court finds the annuity to be nothing more than a conduit for trust income, the transaction should be classified as a transfer in trust. If the court finds that the annuity was not a mere conduit, it should analyze the formal documents of the transaction to determine whether the taxpayer has expressly retained control. If the annuitant has retained control over the transferred property, the transaction should be classified as a transfer in trust. If the documents do not reveal a clear retention of control, the court must examine the substance of the transaction to determine whether the annuitant has retained control through indirect mechanisms. Again, if the annuitant has retained control, the transaction should be classified as a transfer in trust. Finally, the court should examine whether the annuitant is “disinterested,” that is, whether the transaction was at arm’s length, whether the trust itself has any substance beyond the property which the taxpayer transferred to it, and whether the taxpayer has retained any continued interest in the trust other than as a mere creditor. If the taxpayer is found to be disinterested, the transaction should be classified as a sale.

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