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Robert O. Loftis Jr.
Campbell University School of Law, loftisr@campbell.edu

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Problems in the Use of Trusts for Funding Private Annuities

ROBERT O. LOFTIS, JR.*

Annuities¹ are attractive investment vehicles for many persons primarily because they guarantee income for the life of the recipient. The payments continue for the life of the investor, even after his invested capital has been returned. This feature makes annuities favorites of the public, especially for investors at or approaching retirement age. The price which must be paid for this safety feature, however, is the loss of some portion of the original bargain if the recipient does not live at least as long as his or her life expectancy.

Since an annuity is merely an exchange of property for a promise to pay a periodic sum for the rest of the annuitant's life or for some other period, annuities have long had the potential for adaptation to other than ordinary situations.² A private annuity, one of these unusual situations, is nothing more than an annuity acquired from a person or entity other than a commercial insurance company or other organization which periodically issues annuities. Private annuity arrangements offer the advantages of being able

* Professor of Law of Taxation, Estate Planning, Corporate Tax and Business Planning, Campbell University School of Law; J.D., Emory University, 1972; C.P.A.

1. A person who owns an annuity has a right to receive fixed or certain periodical payments, without contingency, either perpetually or for life or a stated period of time; and the determining characteristic of an annuity is that the annuitant has an interest only in the payments themselves and not in any principal fund or source from which they may be derived.

2. A typical annuity is paid by insurance companies. 4 AM JUR. 2D Annuities § 1 (1962).

3. The importance of whether the payments are unsecured becomes critical in terms of taxation. If an annuity is found, a portion of the payments, representing the annuitant's investment, is excluded from income for each and every installment, and the balance is considered income (I.R.C. § 72(b) (1982)); however, if the debt is secured by an interest in the property yielding the payments, the entire amount of the payments is treated as income to the annuitant.

4. A typical annuity is paid by insurance companies. 4 AM JUR. 2D Annuities § 1 (1962).
to purchase an annuity for property other than cash, and of allowing the payor of the annuity to be a related party who will eventually own the transferred property outright.

Private annuities can be used to achieve extremely desirable income, estate, and gift tax results. For example, assume that a life annuity is purchased from a family member in exchange for stock in a closely held corporation. If properly structured, the transaction can produce the following results:

1. No gain or loss will be recognized by the transferror at the time of the exchange, and any gain on the “sale” of the stock (that is, the amount by which the present value of the annuity exceeds the transferror’s “cost” of the stock) will be recognized pro rata as each annuity payment is received (a portion of each payment will also be ordinary income, as with any annuity);
2. If the present value of the annuity payments is equal to the

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3. The new tax reform bill, passed by Congress in the summer of 1986, is expected to have only peripheral effects on the tax treatment of annuities. For example, the elimination of the long-term capital gain preference and a requirement that most trusts use a calendar year for reporting purposes may affect the administration of an annuity, but not its structure.

4. Throughout this Article, the terms “transferror,” “taxpayer” and “annuitant” refer to the person establishing and ultimately benefiting from the investment. “Transferee” and “payor” refer to the person responsible for making the annuity payments.

5. The Internal Revenue Service (hereinafter “IRS”) set out its position on the taxation of private annuities in Rev. Rul. 69-74, 1969-1 C.B. 43. Under this ruling, each annuity payment has three elements: annuity income, recovery of basis, and gain on the sale of the transferred property. The gain to be recognized is the difference between the present value of all of the annuity payments and the transferror’s basis of the property conveyed to the payor (that is, the amount the transferror originally paid for the property). This gain is reported by the annuitant pro rata over his life expectancy as each payment is received. This gain can be accorded capital gains treatment, if on capital gain property, for the life expectancy of the annuitant, but becomes ordinary income once he outlives this time. Under the annuity rules of I.R.C. § 72, which the Ruling purports to modify to fit the peculiarities of the private annuity, a taxpayer may exclude from income that portion of the payment which represents a return of his original cost. In this example, the “cost” of the annuity should be the fair market value of the stock, that is, what the annuitant gave up in return for the annuity. Under normal annuity rules, this portion is excluded as long as annuity payments are received, producing a “windfall” if the annuitant outlives his originally-computed life expectancy. Therefore, even in a private annuity transaction, once all the original gain has been reported, that portion of the payment should be excluded under the normal annuity rules, a position differing from that taken by the IRS.

However, the IRS’s position concerning valuation may have been abandoned or at least overruled. See, e.g., 212 Corp. v. Comm’r., 70 T.C. 788 (1978), and Estate of Bell v. Comm’r., 60 T.C. 469 (1973), where the Tax Court first held that the fair market value, rather than the basis, of the property is the amount to be recovered as basis of the annuity to the point that the fair market value does not exceed the present value of the annuity payments at which time any excess is treated as a gift; and second, ruled that the difference between the basis of the annuity and the basis of the property transferred for the annuity is taxable in the year of the exchange rather than spread ratably in each of the annuity payments. This latter holding was apparently reached because the taxpayer tried to retain the property as security for the payments. Arguably, this can be avoided, and any difference between the present value of the annuity payments and the basis of the property can be reported over the life of the payments, if the taxpayer surrenders all rights to the property.
value of the property transferred (which it should be), there will
be no gift as a result of the transaction; and
3. Upon the transferror's death, the payments will cease and the
transferee will own the stock outright with nothing being in-
cluded in the transferror's estate for estate tax purposes.7

Despite its apparent attractiveness in many family situations,
the private annuity has been cited as one of the most talked about
and least used vehicles in the field of taxation.8 Assuming this is
so, there appear to be at least three factors which account for this
result: First, the IRS's vigorous resistance to the private annuity
concept;9 second, the uncertainty and complexity of the tax conse-
quences in a private annuity transaction;10 and third, the difficulty
in structuring a transaction so that the annuitant has any security
other than the payor's promise to pay.11

In spite of the apparent paucity of the use of the private annu-
ity, a practitioner may well consider it in certain situations. While
the first and second factors cited above still remain to some de-
gree, a trust can solve some of the annuitant's concerns of receiv-
ing only a promise of future payment without violating the rule
that the transaction cannot be secured.12 While no direct security
interest exists, the trust does provide some measure of security to
the annuitant by having the transferred property held in a sepa-
rate fund which is not yet available to the ultimate beneficiaries

6. Under Rev. Rul. 69-74, supra note 5, the value of the annuity must be determined
employed if the annuity was for a person who died between January 1, 1970 and December
1, 1983.) To ensure that the value of the property is equal to this amount, careful apprais-
als should be obtained where necessary. In structuring a private annuity transaction, the
appraisal should come first, and then the annuity amount can be computed using the tables.

7. This assumes the absence of a gift element and no survivor element in the annu-
ity. If the annuity were to provide for both joint and survivor payments, then the value of
the survivorship feature would be included in the transferor's gross estate under I.R.C. §
2039(a) (1982).

8. See Covey, Estate, Gift and Income Taxation - 1969 Developments, U. MIAMI
1969 INS. ON EST. PL. ¶ 70.102.1; Ekman, Private Annuities Revisited, U. MIAMI 1974
INS. ON EST. PL. ¶ 74.1100.

9. The IRS tried to push legislation through Congress in the 1950's and 1960's
which would have altered the taxation of private annuities. Since then, the IRS apparently
has pursued a policy of gradual erosion of private annuities by attempting to make the
structuring of such transactions increasingly difficult.

10. The tax consequences to the annuitant are indefinite as illustrated throughout
this article. The payor apparently is governed by the rules set out in Rev. Rul. 55-119,
1955-1 C.B. 352 which can be adverse in many situations, but are beyond the scope of this
particular inquiry.

11. The taxpayer attempted to retain the property as security for the annuity in both
212 Corp., 70 T.C. 788 and Estate of Bell, 60 T.C. 469. In both cases, the court held the
entire gain was realized in the year of sale because of the security feature.

12. If a transferror receives more than a bare promise to pay, the transaction is
considered a secured obligation for tax purposes and the desired deferral of taxes is not
available. See supra note 5.
but which is supervised by a trustee. A series of recent cases have
dealt with the consequences of using a trust in a private annuity
situation.\textsuperscript{19} The purpose of this Article is to analyze those cases, to
point out the problems in this area, and to suggest ways in which
private annuity transactions with trusts can be structured to avoid
as many of those problems as possible.

I. PROBLEMS WITH TRUSTS

The major problem when property is transferred to a trust in
exchange for a promise to pay an annuity is that the IRS can
attack the transaction as a transfer in trust with a retained life
interest. This results in adverse income tax\textsuperscript{14} and ultimately ad-
verse estate tax consequences.\textsuperscript{15} Since both an annuity and a re-
tained life interest share the feature of payments being made for
the payee's life, the courts often have difficulty in articulating sub-
stantial differences between them.\textsuperscript{16} Adding to this area's confu-
sion is that the litigated cases generally involve situations where
the transfers and the payments made by the parties depart from
those required by the underlying documents.\textsuperscript{17}

One of the earliest cases to consider this problem was \textit{Lazarus
v. Commissioner}.\textsuperscript{18} In that case, the taxpayer entered into an ir-
revocable trust agreement with a Bahamian trust company for the
benefit of his children and numerous other relatives. While the
trust was initially funded with $1,000 in cash, the taxpayer in-
tended to transfer a shopping center to the trust. The trustee
agreed to accept the property only if the shopping center were

(1981), \textit{rev'd}, 747 F.2d 555 (9th Cir. 1984); (Enright, J., Dissenting) LaFargue \textit{v.
Comm'r}, 73 T.C. 40 (1979), \textit{rev'd}, 689 F.2d 845 (9th Cir. 1982); Lazarus \textit{v. Comm'r}, 58
T.C. 854 (1972), \textit{aff'd}, 513 F.2d 824 (9th Cir. 1974); Horstmier \textit{v. Comm'r}, 46 T.C.M
(CCH) 738 (1983). Most of these cases involved foreign trusts, established apparently for
the benefit of his children and numerous other relatives. While the
trust was initially funded with $1,000 in cash, the taxpayer inten-
tended to transfer a shopping center to the trust. The trustee
agreed to accept the property only if the shopping center were

14. Under I.R.C. § 677(a) (1982), the grantor of a trust is treated as the owner of
any portion of a trust whose income is distributable to him. Under I.R.C. § 671 (1982), the
grantor-owner is taxed on the trust's income. The IRS attempts to characterize the annuity
payments as a distribution of the trust's income, and thus taxable to the grantor.

15. Under I.R.C. § 2036(a) (1982), if a decedent makes a transfer of property for
less than adequate consideration and retains a right to its income for life, the value of the
property is included in his estate.

16. Differences other than of form may, in fact, be minor. However, this does not
solve the problem but merely states it: Do we have a gift to a trust with a retained life
interest, or a sale to a trust in exchange for an annuity? This inherent problem is caused by
the common use of a trust, and the similarity between a life interest and an annuity.

17. \textit{See supra} note 13. All of these cases except \textit{Estate of Fabric} had this same
problem to a greater or lesser extent.

incorporated and the trustee was authorized to dispose of the stock almost at once. The taxpayer transferred the property to a newly-formed corporation in exchange for its stock. He then transferred the stock to the trustee in exchange for an “annuity” of $75,000 per year to him or his wife as long as either was alive. Shortly thereafter, the trustee sold the stock to another Bahamian corporation for a $1,000,000 non-negotiable promissory note, providing for a $75,000 annual interest payment and principal due in full in twenty years. The note also had a provision which allowed the trustee to call for an acceleration and redetermination of the note principal at any time within the first eighteen years. The underlying property was to be appraised as of a specified date between one and two years after notice of the appraisal and the principal of the note to be adjusted to the appraised value. The appraisal procedure also triggered a different principal repayment schedule.

The taxpayer treated the exchange with the trust as a sale of the shopping center stock in return for the promise to pay an annuity. The Government contended that the substance of the transaction was not a sale but a transfer of property to a trust for the benefit of the taxpayer’s children and others, subject to a reservation of the income of the trust for the life of taxpayer and his wife. The Tax Court found for the Government and the Ninth

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19. The trustee also insisted that management be found for the center. At about that same time, the taxpayer formed another corporation which entered into a management contract with the shopping center.

20. The taxpayer and his wife had a joint and survivor life expectancy of 21 years. The parties stipulated that the fair market value of the stock and the shopping center property was $1,575,000 ($75,000 times 21). However, using the IRS’s tables and the $75,000 payments, the actuarial value of the payments was $864,533, a fraction of the stipulated value of the stock and property.

21. The stock and the underlying property were transferred several times subsequent to this sale. Apparently, neither the taxpayer nor his family had any subsequent direct or indirect interest in the property.

22. The Tax Court found that the “only reasonable inference” was that this sale was contemplated while the trust was being negotiated. Lazarus, 58 T.C. at 865.

23. The buyer had the option of returning all assets to the Trustee in full payment of the note if it did not wish to accept the appraised value.

24. Rather than the entire principal being due at once, it would be payable $100,000 per year, with appropriate interest adjustments.

25. The taxpayer reported the transaction as an “open” one, treating the annual $75,000 payment as first a recovery of the $718,406 basis in the property (the transferred stock) before reporting any gain. See Burnet v. Logan, 283 U.S. 404 (1931). This approach was disapproved in Rev. Rul. 69-74, supra note 5, and has been uniformly rejected by the courts in the private annuity area since the ruling was issued. See 212 Corp., 70 T.C. 788 and Estate of Bell, 60 T.C. 469.

26. This position has a two-fold effect: First, the amount received by the taxpayer is treated as a distribution of trust income under I.R.C. §§ 674 and 677 (1982), making the entire $75,000 received ordinary income in this instance; and second, the value of the property will be included in the taxpayer’s estate under I.R.C. § 2036, as a gratuitous transfer.
Circuit Court of Appeals affirmed.\textsuperscript{27} The appellate court stated that, in determining which type of transaction had occurred, substance, not form, controlled.\textsuperscript{28} The court further affirmed the Tax Court's holding that, since the trust, annuity and note were all part of a prearranged plan, "no one of them would have been signed without the other; each was dependent on the other . . ."\textsuperscript{29} such that all must be considered together. The appellate court found that the Tax Court reasonably concluded that in substance the transaction was a transfer in trust with a retained life estate rather than a sale to the trust in exchange for an annuity. The court summarized the factors found by the Tax Court to lead to this conclusion as follows:

(1) The only source of the "annuity" payment was the property transferred to the trust in exchange for the annuity, which was "an arrangement more characteristic of a trust than a bona fide arms-length [sic] sale";
(2) Since the note was neither negotiable nor assignable, payments could not be made out of the corpus of the trust. The interest on the note, which was the trust's only income, was exactly equal to the "annuity" payments due each year;
(3) The arrangement was designed in such a way that the corpus of the trust would remain intact for ultimate distribution to the beneficiaries in precisely the same way as if the transaction had been a transfer in trust subject to a reservation of trust income;
(4) "The arrangement did not give [the taxpayer] a down payment, interest on the deferred purchase price, or security for its payment, again more characteristic of a transfer in trust than a bona fide sale"; and
(5) "There was a substantial disparity between the fair market value of the stock transferred and the actuarial value of the 'annuity' payments".\textsuperscript{30}

The court held that while no one factor was controlling, together they supported the Tax Court's conclusion.\textsuperscript{31}

Several years later, the Ninth Circuit considered another private annuity-trust case on appeal from a Tax Court decision in favor of the Commissioner.\textsuperscript{32} This time, however, the appellate court reversed. The facts have some similarity to \textit{Lazarus}, but with a retained life estate. Thus, this defeats all the annuity advantages the taxpayer sought.

\textsuperscript{27} 513 F.2d 824 (9th Cir. 1974).
\textsuperscript{28} This has been a long-standing tax principle, applicable in many different areas. See, e.g. Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958); Helvering v. Clifford, 309 U.S. 331 (1940).
\textsuperscript{29} \textit{Lazarus}, 58 T.C. at 866.
\textsuperscript{30} \textit{Lazarus}, 513 F.2d at 829.
\textsuperscript{31} Id. at 829.
\textsuperscript{32} \textit{LaFargue}, 689 F.2d 824 (1982).
substantial differences also existed. The taxpayer in *LaFargue* established a trust for the benefit of her daughter with an initial funding of $100.33. Two days later, the taxpayer and the trustees executed an “Annuity Agreement” wherein she transferred property worth $335,000 to the trust in exchange for the trustees’ promise to pay her $16,502 per year for the rest of her life. Since no discount factor was used, the present value of the annuity was significantly less than the value of the property transferred.

As in *Lazarus*, the Commissioner contended that the transfer should be treated as a transfer in trust with payments retained for life. The Tax Court concluded the Commissioner was correct and that the transaction was in substance the creation of a trust with retained annual payments. Rather than repeating all the criteria involved in this type of transaction, the court focused its analysis on the specific elements of similarity and difference between this case and *Lazarus*. The court set out the following factors:

1. The trust and annuity were part of a prearranged plan, and as such, the trust would have been an empty shell without the annuity property;
2. The taxpayer could look only to the transferred property itself as the source of the annual payments. Although the identification of the source here was not as direct as in *Lazarus*, and might well have been less significant, the court felt it still should have been given considerable weight in evaluating the total circumstances;
3. The lack of a direct relationship between the purported sale price (the present value of the annuity payments) and the fair market value of the property transferred was found to be uncharacteristic of an arm’s-length sale. The court pointed out that the absence of a down payment and lack of security would clearly point to a premium rather than a discount if the transac-

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33. The trustees in this case were her sister, a family friend and her attorney. The Tax Court found that only her attorney had any experience in trust administration. *LaFargue*, 74 T.C. at 43.
34. These assets included a one-third interest in a non-income producing parcel of land, proceeds from the liquidation of a family business, assorted stocks and municipal bonds.
35. At the time of the agreement, Mrs. LaFargue’s life expectancy was 20.3 years using the mortality tables in Table I, Treas. Reg. § 1.72-9 then in effect (20.3 times $16,502 equals approximately $335,000).
36. Using the six percent tables in Treas. Reg. § 20.2031-10(f) then in effect produced a present value of $176,990 for the annuity according to the Tax Court. *LaFargue*, 73 T.C. at 51.
37. See supra notes 14 and 15.
39. See supra note 36.
tion were at arm’s-length;\textsuperscript{40}

4. The lack of an interest factor was another indication of the absence of an arm’s-length transaction, and that an interest factor is usually present when an annuity is involved;

5. Several informalities in the administration of the transfer and subsequent payments suggested the taxpayer viewed herself more as the beneficial owner of the property than as a creditor;\textsuperscript{41}

6. While the precise tie-in between the income of the trust and annual payment which existed in \textit{Lazarus} was lacking, \textit{Lazarus} did not represent the outer limit “for determining that a purported transfer of property for an annuity in reality constitutes a transfer of trust”\textsuperscript{42}\textsuperscript{ and the lack of that factor was not controlling here.

The court concluded that in view of the foregoing, the transfer should be treated as a transfer in trust with a retained interest. The court went on to state that it was not holding that there could never be an arrangement which would qualify as a bona fide sale to a trust in exchange for an annuity, but that it had serious doubts that such a transaction could ever qualify if the property was to be the sole source of the annuity payments.\textsuperscript{43}

The Ninth Circuit reversed.\textsuperscript{44} The court stated that the annuity characterization comported with the formal structure of the transaction and accurately reflected its substance. The agreement established the annuitant’s status as a creditor of the trust and the fundamental annuity obligation had not been ignored. The payments had been made each year, had not fluctuated with the income of the trust, and that absent some indication that the annuity payment was a mere disguise for transferring the income of the trust to the grantor, the disregarding of the formal structure of the transaction as a sale could not be justified.\textsuperscript{45}

\textsuperscript{40} The court made two other important observations here: First, while an annuity usually has no downpayment or security, the issue here was not annuity versus a sale, but rather reserved interest versus sale; and second, the unreality of the alleged sale was reflected in the express negation of a gift and the failure to consider the cost of a comparable commercial annuity.

\textsuperscript{41} For three years, the taxpayer continued to receive some dividends from stocks purportedly sold to the trust. Moreover, annuity payments were not always timely, and the taxpayer did not demand the penalties provided for in the agreement. The taxpayer was included at meetings concerning the administration of the trust and testified that she expected to be kept informed about trust investments. She also testified that she wanted an arrangement providing for the management of her property. The trust beneficiary testified that the purpose of the trust was primarily to preserve the assets and provide for her mother.

\textsuperscript{42} \textit{LaFargue}, 73 T.C. at 57.

\textsuperscript{43} \textit{Id.} at 58. The court also stated that the degree of clarity in the underlying documentation and the care with which the arrangements were implemented were considerations, but that the totality of the circumstances was controlling.

\textsuperscript{44} \textit{LaFargue}, 689 F.2d at 845.

\textsuperscript{45} \textit{Id.} at 850.
The court went on to address the other points made by the Tax Court. The fact that the annuity had less value than the property transferred was not necessarily indicative of a transfer in trust, but merely indicated that the transaction was partly a gift and partly a sale.\textsuperscript{46} The informalities in the trust administration were to be taken in context: The trustees were friends of the annuitant and her daughter was the beneficiary; moreover, the annuitant did not and could not take an active role in trust management and held no power to control the trustees. The subsequent receipt of $2,200 in dividends on it after the “sale” was, given the fact that the stock represented only a fraction of the property transferred, only a temporary defect and should not serve as a basis for recasting the entire transaction. Similarly, the waiver of late charges on delinquent annuity payments did not, without more, show that the trustees intended to ignore the obligation to pay or that the annuitant did not intend to enforce it.

The court then focused on the Tax Court’s analogy to \textit{Lazarus} and found it to be misplaced. The annuity here was not a “conduit” for the income of the trust; the fact that the trust’s only assets for the payment of the annuity was the transferred property was only a bolster to the \textit{Lazarus} conclusion the arrangement was a conduit. Here, income was sometimes left over after payment to the annuitant, and at other times some corpus was used to make the payments; the payment was not a camouflaged transfer of trust income. The fact that almost all of the trust’s assets were obtained under the agreement had not been shown to have had any practical or legal bearing on the trustees’ obligation or ability to comply with the terms of the annuity contract. The court concluded that the formalities here were in order, that the payments were not a conduit for part or all of the income, and that the annuitant did not actually continue to control the property. Therefore, the court held that formal characterization of the transaction as a sale in exchange for an annuity should not be disregarded for tax purposes.

After its decision in \textit{LaFargue}, but prior to the Ninth Circuit’s reversal, the Tax Court considered another significant case.\textsuperscript{47} In that case, the taxpayer transferred marketable securities to two foreign-situs trust in exchange for a promise to pay him an annuity for life. He, his spouse and his descendants were the benefi-

\textsuperscript{46} This is consistent with the position advocated by the Commissioner and sustained, in a non-trust situation in Estate of Bell v. Comm’r., 60 T.C. 469 (1973).

ciaries of the trusts, although the independent trustee of both trusts, a foreign bank, had absolute discretion to distribute the income and corpus. The taxpayer also had a special power of appointment over the trust assets, and the power to remove the trustee and appoint a successor. The trustee was authorized to make unsecured interest-free loans to trust beneficiaries and to pay premiums for life insurance on the lives of the beneficiaries. The taxpayer carefully reviewed the administration of the trusts after complaining about the fees being charged and eventually changed trustee. The annuity values were properly calculated and thus the present value of the annuity was equal to the fair market value of the property sold.

The Tax Court found, as it had in Lazarus and LaFargue, that the transaction was a transfer in trust with retained annual payments and not a sale in exchange for an annuity. The court emphasized that while no one factor was decisive, the following factors were relevant in reaching its decision: First, the creation of the trusts and the annuity agreements were interrelated, with the consideration for the annuities, for all practical purposes, being the “corpus” of the trusts. Second, the same economic results would obtain whether the transaction was a transfer in trust with a retained interest or a “sale” for an annuity. Specifically, the amount remaining after making the payments would inure to the natural objects of the taxpayer’s bounty. Third, the only source of the annuities was the properties transferred to the trusts and the income derived therefrom. In addition, the taxpayer’s status as a beneficiary of the trusts and the permitted dealings with the trusts, together with the retained powers indicated a continuing interest in the trust and the underlying property which were uncharacteristic of a sale. Fourth, the taxpayer’s actions concerning the trusts’ administration suggested that he viewed himself more

48. Although the taxpayer was not the settlor of the trust, he was treated as such since the trusts were created at his instigation and for his benefit, with only nominal consideration being furnished by the named settlors. Stern, 77 T.C. at 647.
49. The special power of appointment, by which the taxpayer could dispose of all or part of the trust corpus, was exercisable by deed or will in favor of anyone other than the donee, his estate, his creditors, or the creditors of his estate. His spouse had a similar power over the property after his death.
50. The successor trustee had to be a company with trust administration powers and a specified minimum authorized capital.
51. Stern, 77 T.C. at 642.
52. Id. at 644. In addition, the taxpayer represented that the transferred stock was still owned by him on a personal financial statement and apparently assured others, in connection with an unrelated securities problem, that he had never “sold” any of the shares.
53. The court stated that while the trusts were not mere conduits as in Lazarus, that characteristic was not essential to its finding. Id. at 641-42.
as the beneficial owner of the transferred properties than as a creditor of the trusts. Fifth, he claimed to be the owner of the trust properties when it was convenient to do so. Sixth, the position that the stock was "sold" in exchange for an annuity was inconsistent with the statement made that no stock had been "sold."

The court further stated that its decision did not turn on the nature and extent of the taxpayer's control over the property, but rather "on a realistic view of [his] overall relationship vis-a-vis the transferred properties." Therefore, cases relating to specific control issues under other code sections were found not to alter the result reached.

On appeal, the Ninth Circuit again reversed the Tax Court's decision. Relying on its decision in LaFargue, and that case's contrast with Lazarus, the court found the LaFargue rationale to be controlling. The Tax Court's finding that the trusts were not mere conduits for the income from the transferred property was considered determinative. Moreover, the court found that LaFargue indicated that a recharacterization cannot be made merely because the transactions were part of a single prearranged plan or because the transferred property constituted the bulk of the trust's assets. While the court also observed that merely following annuity formalities and not tying the annuity amount to trust income is not alone sufficient to justify annuity characterization, it did not state what additional factors are required other than to again cite LaFargue for the principle that "it is important to scrutinize whether the parties actually did what they purported to do in the formal documents."

The court next addressed the combined effect of the taxpayers' interest and powers in the trust on annuity characterization. The court acknowledged that the taxpayers in Stern did not take an active role in trust decisions nor did they hold a power to control the trust such that the annuity arrangement should be discarded.

54. Id. at 646.
55. Thus, the question of whether the control was sufficient for I.R.C. §§ 674 or 2036 to apply was not critical.
56. Stern, 747 F.2d 555.
57. Id. at 560.
58. Stern, 77 T.C. at 641-42.
59. Stern, 747 F.2d at 558.
60. LaFargue, 689 F.2d at 847.
61. Stern, 747 F.2d at 558 (citing LaFargue, 689 F.2d at 847).
62. Stern, 747 F.2d at 558 citing Samuel v. Comm'r., 306 F.2d 682 (1st Cir. 1962), Bixby v. Comm'r., 58 T.C. 757 (1972). In Bixby, the annuitants could serve on an "advisory committee" with plenary powers over the trust assets, could remove the trustee, and could receive interest-free unsecured loans from the trust. Additionally, the trust could pay premiums for insurance on their lives. Samuel involved facts even more adverse to the
Further, the court found that nothing analogous to an "advisory committee" existed, nor did either taxpayer have a "free hand" over the disposition of the trust assets. While the taxpayers kept close track of the trustee's performance and eventually changed trustees, the court found that these actions did not amount to sufficient control to recharacterize the transaction. The court observed that this conclusion was strengthened by the values of the annuities being equal to the fair market value of the property transferred, unlike LaFargue, and thus reducing the chance that large amounts of unexhausted corpus would pass to others upon the death of the annuitants.

The court's opinion was not unanimous, however, and the dissent makes clear that this was a close case that should not be considered as a pattern for planning purposes. The dissent argued that in LaFargue "[t]he taxpayer was neither a trustee nor a beneficiary, and the court expressly stated that she held no power to manage the trust or control the independent trustees." The dissenting judge felt that there was sufficient control on the taxpayer's part to justify sustaining the Tax Court, and the majority's reading of the LaFargue "mere conduit" test was much too simplistic.

Following Stern, the Tax Court found for the taxpayer in several additional cases, following its Golsen rule. In the most recent case that the Tax Court has considered, however, it found the annuity transaction again invalid. In Weigl v. Commissioner, the taxpayer-husband transferred his interest in certain stock options to a Bahamian trust in 1968 in exchange for a properly valued taxpayer and actually consisted of a gift in trust with a retained income interest which the taxpayer unsuccessfully tried to recharacterize as a sale for an annuity after the trust had sold the gifted property. The court in Stern found that the taxpayers there did not possess the degree of control over the trust that was present in both Bixby and Samuel. Stern, 747 F.2d at 559. The Tax Court had previously acknowledged this finding. Stern, 77 T.C. at 645-46.

63. Stern, 747 F.2d at 559 n.7.
64. Id. at 559-60.
65. Id. at 561.
66. Id. at 562 (citing LaFargue, 689 F.2d at 848).
67. Stern, 747 F.2d at 562 n.3. The dissent argued that the extended discussion of control factors in LaFargue indicated that the conduit test was not determinative.
69. In Golsen v. Comm'rs, 54 T.C. 742, 757, (1970) cert. denied, 404 U.S. 940 (1971), the court stated: "[B]etter judicial administration. [sic] requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone."
70. 84 T.C. 1192 (1985).
private annuity. Created by a business associate of the taxpayer, the trust was funded with $5,000 and the taxpayer's wife was named sole beneficiary. The wife was given a special power of appointment over the corpus, and could name an "Advisory Committee" to direct trust investments. The trustee's obligation to make the annuity payments was limited to trust assets. The beneficiary was never told of the trust's existence and she executed documents at her husband's request, often without reading them. The trust subsequently made a $400,000 interest-free unsecured loan to her of which she was unaware since her husband received the funds directly from the trust and used them in his business.

The court held that this was not a sale for an annuity, but a transfer in trust by the taxpayer with a retained interest. The court held that the taxpayer had retained effective control over the property through his wife's power to appoint the assets in his favor, since he made all her business and financial decisions. In reaching its decision, the court also mentioned the taxpayer's negotiation of the sale of trust assets, the trustee's apparent lack of independence and the wife's right to name the taxpayer as the sole member of the advisory committee. The court also found a tie-in between the annuity obligation and the trust's income due to the trust's failure to make the annuity payments after a default on the unsecured loan. Due to the relationship between the creation of the trust and the other transactions, the court found the taxpayer was the grantor of the trust, making the grantor trust rules applicable.  

II. ANALYSIS OF FACTORS CONSIDERED BY THE COURTS

In early cases courts began their analyses, which are often incorporated without comment in later cases, with the well established tax principle that the substance of a transaction, and not its form, controls the consequences, unless a particular statute indicates that form is to govern. However, "[r]eferences to 'substance over form' . . . merely restate the issue in cases like this. . . . What is substance and what is form? Moreover, they do so in a way which makes it appear that these questions can be answered simply by viewing the facts with appropriate

72. While Weigl has not yet been appealed, a decision by an appellate court may not give much guidance to a taxpayer to properly structure a private annuity. The taxpayer in Weigl made so many errors in structuring his investment that an appellate court could base its ruling on a factor which would not aid other taxpayers considering a private annuity. Nevertheless, the tax court's opinion should be heeded as another warning that effective control will be determinative that an investment is a transfer in trust with a retained interest.

73. See supra note 28.
While the "substance versus form" principle sets the scene and guides the analysis, the principle alone is no solution. Further, this proposition does not give the IRS or the courts carte blanche to restructure every transaction. This principle can and should be used, however, to reclassify transactions where the purported form is substantially different from the actual substance, especially where the intent of the underlying statute is at odds with the substance of the transaction. In the private annuity area, however, the only form for such a transaction is found in the general annuity statute which, to date, has never been at the heart of any of the disputes. Since inquiry into substance is thought to be a method of analysis rather than a solution, we return to the question posed above: What is substance and what is form?

The alternatives under consideration are: 1) a sale to a trust in return for a promise to pay a private annuity, or 2) a transfer in trust with a retained or reserved income interest. One way to analyze the problem would be to determine the characteristics of each type of transaction, ignore the characteristics they have in common, and then in each particular situation determine whether a preponderance of dissimilar characteristics tilts the scales in one direction or another.

Before such an analysis can begin, however, a threshold question must be answered: Can a valid private annuity transaction with a trust ever be structured so as to avoid the grantor trust rules? The Tax Court has expressed some doubt upon the matter, at least with respect to otherwise unfunded trusts. The service has on at least one occasion, however, seemingly approved the use of an otherwise unfunded trust. Certainly the Ninth Circuit feels such transactions are possible and none of its opinions, nor those of Tax Court for that matter, imply that the Government has made the argument that such transactions will always run afoul of

75. This was the situation in Gregory v. Helvering, 293 U.S. 465 (1935), where the doctrine was first formulated.
76. I.R.C. § 72.
77. This is essentially the same process as that adopted by the IRS in Treas. Regs. § 301.7701-2 (1983), relating to whether an unincorporated association should be classified as a corporation for tax purposes. This requires another substance versus form determination.
78. "We note, however, that we have serious doubts whether section 72 rather than the grantor trust provisions of sections 671 through 677 would apply to any situation where the assets transferred to the trust are the engine designed to fuel the so-called annuity payments." LaForgue, 73 T.C. at 58.
79. Rev. Rul. 77-454, 1977-2 C.B. 351, where the IRS addressed the gift tax implications of a transfer to an essentially unfunded trust with apparent approval of the validity of the annuity arrangement.
sections 677 and 2036. Therefore, assuming that a possibility exists of structuring a sale of property to an otherwise unfunded trust in exchange for a promise to pay an annuity, we can proceed to an analysis of the differences between that situation and a transfer to a trust with a retained income interest. The courts have used different factors in analyzing each of the cases, but something of a consensus has been reached as to which factors are important.⁸⁰

In all of the litigated cases⁸¹ the trusts involved were found to have been created with a nominal corpus⁸² for the apparent sole purpose of entering into the annuity transaction. While some of the trusts were nominally created by persons other than the annuitant,⁸³ the courts have had no difficulty in treating the annuitant as the grantor in every case.⁸⁴ This enables the court to view the creation of the trust and the “sale” of the property for an annuity as steps in an interdependent series of transactions.⁸⁵

An important question is whether the interdependence of trust creation and transfer of property truly has any relevance to the question of whether a valid sale occurred? A second question is that if a preexisting trust with a substantial corpus and beneficiaries who were the natural objects of the taxpayer’s bounty existed, would a purported sale of property to the trust in exchange for a promise to pay an annuity be any more or less valid than

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⁸⁰ See supra note 30 and accompanying text.
⁸¹ See supra notes 13 and 62 for a list of some such cases.
⁸² While the amount has varied from $5 in Benson v. Comm′r., 80 T.C. 789 (1983), to $5,000 in Stern v. Comm′r., 77 T.C. 614 (1981), rev′d 747 F.2d 555 (9th Cir. 1981) (Enright, J., Dissenting) and Weigel v. Comm′r., 84 T.C. 1192 (1985), the amounts were still an insignificant sum in the context of the entire transaction.
⁸⁴ In two cases, the Tax Court cited the following factors as leading to the conclusion that the taxpayer was the true grantor: (1) the value of property transferred to the trust by the taxpayer was substantial compared to the nominal amount transferred by the named settlor; (2) the creation of the trusts and the private annuity transactions occurred at nearly the same time; (3) the taxpayer and his attorney orchestrated the entire arrangement; and (4) the named beneficiaries of the trusts were the natural objects of the taxpayer’s bounty. Stern, 77 T.C. at 647; Horstmier, 46 T.C.M. at 756. The Ninth Circuit opinion reversing Stern made no mention of the nominal settlor as a factor in its decision and spoke of the taxpayer as if he were the grantor. For the tax consequences of finding the annuitant to be the grantor, see supra note 14.
⁸⁵ If the annuitant is the named “grantor” of that trust, or if the issue is being raised in an estate tax case, the interdependence of the transaction is not crucial. If the taxpayer is the named grantor, the only question is whether there is a valid annuity obligation or whether the transaction merely provides for the distribution of the trust’s income to the grantor. In the estate tax situation, the identity of the grantor of the trust is not relevant. The issue is whether the decedent’s transfer was gratuitous with a retained interest. If the annuity obligation is recognized, it becomes the consideration for the transfer, eliminating any gift element if properly valued.
such a sale to a newly-created trust?

That validity would differ in these two situations is difficult to understand, at least on interdependency grounds. In either case, the transferror wanted a trust to be the buyer, for one or more reasons:86 Concluding that the circumstances underlying the creation of the trust have any genuine relevance as to whether the transaction was an annuity or a retained interest is difficult to justify. All that interdependency seems to mean is that the taxpayer decided to enter into a private annuity transaction. Rather than “sell” the property to a corporation, individual, or other existing entity, the taxpayer chose to create a trust to be the annuity payor with the benefits inherent in having a fiduciary hold the property. There are no apparent reasons to make the annuity transaction more or less valid depending upon the taxpayer’s choice.

In the first place, stating that the annuity and trust were decided upon at the same time says nothing about their substance or validity. Second, any issue which arises about the solvency of the payor is distinct from the creation of the trust. This solvency concern should be treated directly on its merits as discussed in the source of payment issue,87 and should not be given any greater weight than it otherwise warrants by giving it double consideration under the guise of an interdependence issue.

The presence of a direct relationship between the income generated by the transferred property and the amount of the annuity payments is certainly a relevant factor in determining whether a valid annuity exists. If the amount of the annuity payment and the income generated by the property are identical, a strong, indeed almost conclusive, presumption arises that the “annuity” is merely a retained income interest.88 This conclusion assumes, of course, that a systemic, and not merely coincidental, relationship exists between the two amounts.89 Conversely, the absence of a one-to-one relationship may be indicative of a true annuity. Annuities properly should include an interest or income element as well as a return of a major portion of the principal over the annuitant’s

86. See supra note 12 and accompanying text.
87. See infra text accompanying notes 103-04.
88. This was a central factor in the Lazarus decision, 513 F.2d 824, as illustrated in the subsequent Ninth Circuit decisions in LaFargue, 689 F.2d 824 and Stern, 747 F.2d 555.
89. The Lazarus situation, where the “annuity” was structured to require payment of an amount equal to the interest payment on the property “sold” to the trust, should be distinguished from a coincidental or less abusive situation. The IRS mandates the use of annuity tables based on a 10% return. See infra note 92. A negative inference should not be drawn if investments could be found which provided a current return sufficiently in excess of 10% to cover the entire payment. However, the entire arrangement being orchestrated by the annuitant in advance might be suspect.
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life expectancy.\textsuperscript{90} Therefore, payments structured in this manner wear the badge of a true annuity. In evaluating this factor, however, one should keep in mind that the IRS has mandated strict procedures for determining the annual payments for private annuities.\textsuperscript{91} These procedures may produce results quite different from those obtained with commercial annuities or using current rates of return.\textsuperscript{92} Taxpayers should certainly not be penalized for following IRS procedures in this area.\textsuperscript{93}

Attempts by taxpayer-sellers to retain control of properties after the "sale" to the trusts have resulted in a determination that the transaction was a retained interest rather than an annuity. The attribute of continued control has been the keystone of two Tax Court decisions,\textsuperscript{94} and merely one factor of several in others.\textsuperscript{95} In some cases, the type of control which has been specifically prescribed has been actual, continuing direct control over the assets purportedly transferred.\textsuperscript{96} In other cases, the IRS has maintained that less obvious powers had the effect of a retention of control.

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\textsuperscript{90} This is the essence of normal annuity taxation under I.R.C. § 72. The interest element is taxed as ordinary income while the taxpayer is allowed to recover the cost of the annuity tax-free in a pro-rata manner over his estimated life expectancy.

\textsuperscript{91} See, e.g., the Commissioner's calculations in Rev. Rul. 69-74, supra note 5.

\textsuperscript{92} The courts have rejected the use of comparable commercial annuities as a basis for determining the value of a private annuity. They have cited expert testimony as to differences between the two, which increase a commercial provider's cost. See 212 Corp. v. Comm'r., 70 T.C. 788, 798 (1978); Estate of Bell v. Comm'r., 60 T.C. 469, 474 (1973). Rev. Rul. 69-74, supra note 5, requires the use of the annuity tables in Treas. Regs. § 20.2031-7 for valuing a private annuity. The above cases upheld its use in spite of the fact that it was based on 1939-1941 mortality data and a 6% interest rate. The Regulations have since been revised to reflect updated mortality data and a 10% interest rate, effective May 10, 1984.

\textsuperscript{93} The Tax Court cited several factors which are at odds with the single-method valuation prescribed by the IRS. In LaFargue, 73 T.C. at 55, it stated: "Moreover, the unreality of the claim of a bona fide sale is also reflected by . . . the failure of [the annuitant] to consider how much a comparable annuity from a commercial institution would have cost."

\textsuperscript{94} In Bixby v. Comm'r., 58 T.C. 757, 789 (1972), the Tax Court stated:

To us it is obvious that the entire transaction was designed to allow petitioners to maintain control over the property transferred and its proceeds, while claiming the benefits of so-called private annuities. . . . [T]he maintenance of control is the key to deciding this issue . . . .

The test of control that can be drawn from Samuel [306 F.2d 682 (1st Cir. 1962)] is an eminently practical one. Did the purported annuitant transfer so many incidents of ownership that it can be said that he or she no longer has effective control over the property?

See also Weigl v. Comm'r., 84 T.C. 1192 (1985).

\textsuperscript{95} See Stern, 77 T.C. 614, and LaFargue, 73 T.C. 40.

\textsuperscript{96} In Bixby, 58 T.C. 757, each trust provided for the naming of an "advisory committee" with plenary powers over the trust assets, whose membership was composed of close friends and relatives of the annuitant and to which the annuitant could be named. In Weigl, 84 T.C. 1192, the taxpayer-annuitant could have been appointed the sole member of a similar "advisory committee" and could have actually dealt with the assets involved as if he had been a member of the committee.

Specifically, power of the transferror to change the trustee,\textsuperscript{97} as well as informal arrangements whereby the transferror was kept informed of trust investments and investment plans,\textsuperscript{98} have been attacked.

However, such attacks have met with mixed success\textsuperscript{99} and these factors ultimately appear to be make-weight arguments where other, more onerous, factors are present. One aspect of potential control which the courts and the IRS have not directly addressed is that type of control inherent in arm’s-length debtor-creditor relationships. Since in a valid annuity the relationship between the annuitant and the trust is one of creditor-debtor, any restraint or control possessed by the annuitant solely in the capacity of a creditor should be viewed as a positive indicia of a valid annuity and not as a prohibited control power. There should certainly be, at worst, only a neutral consequence to this relationship. Such factors as a security interest in assets and periodic reports on the condition of the trust should also be permissible.

The courts have carefully scrutinized whether annuitants had a continuing interest in the transferred properties. This “continuing interest” could be viewed as a variation of the “control” question, since the courts seem to be asking whether annuitants had some involvement in the individual assets transferred and not whether annuitants had a concern as to the adequacy of the total fund.\textsuperscript{100} In several cases, annuitants have kept themselves informed about the individual assets of the trust long after their ownership interests purportedly ceased.\textsuperscript{101} In situations where no ability to directly control existed yet annuitants kept or were kept informed about the details of the trust assets, the courts have found a continuing interest which undermined the annuitants’ position. In these contexts, a continuing interest in trust assets is deemed to be more indicative of a transfer in trust with a retained interest than a sale for an annuity.\textsuperscript{102} A true annuitant may care about the solvency of

\textsuperscript{97} See Stern, 77 T.C. 614.
\textsuperscript{98} See Estate of Fabric v. Comm’r., 83 T.C. 932 (1984); Stern, 77 T.C. 614; and LaFargue 73 T.C. 40.
\textsuperscript{99} The Tax Court found these arguments relevant in Stern and LaFargue, but they were viewed as unpersuasive on appeal.
\textsuperscript{100} In Bixby, 58 T.C. at 789, the court summarized this problem as follows: In the Samuel case the Court of Appeals for the First Circuit analyzed the normal annuity situation in the following terms:
“once the annuitant has transferred the cash or property to the obligor and has received his contractual right to periodic payments, he is unconcerned with the ultimate disposition of the property transferred * * * * * [Samuel v. Comm’r., 306 F.2d 682, 687 (C.A. 1, 1962). . . .]
\textsuperscript{101} See supra note 98 and accompanying text.
\textsuperscript{102} See the Ninth Circuit’s analysis in Stern, 747 F.2d 555, which expressed concern about this type of continuing interest, but held it fell short of the control present in
the payor, but would have no concern about the particular assets transferred. Again, as discussed above, an annuitant’s interest as a creditor should not be viewed as an adverse factor. To the extent that the interest goes beyond that, however, the interest may have some probative value indicating a transfer in trust.

The source of the annuity payments has been another factor used by the courts in differentiating between a transfer in trust and a sale for an annuity. One of the major characteristics of an annuity is that it provides a stream of payments which the annuitant cannot outlive. The payor has determined, based on actuarial calculations, that a sufficient number of annuitants will die before their calculated life expectancies to more than compensate for those who live substantially beyond their projected lifetimes. But, each particular annuitant can generally rely on the general credit of a life insurance company or other large payor of the annuity which guarantees that sufficient funds will be available to make the payments regardless of the annuitant’s lifespan.

Since each annuity payment is a mixture of income and principal, however, a possibility, and even a likelihood, exists that an annuitant could exhaust the original funds transferred if he lives longer than his projected life expectancy. Therefore, if the assets transferred to the trust in exchange for the annuity constitute substantially all of the trust’s corpus, a chance that funds could be exhausted before the annuitant’s death exists. In several cases, the courts have treated the fact that the taxpayer could look only to the transferred property and its income as a source for payment as giving the transferror a continuing interest in those properties. While this may be a true statement, the inquiry should remain whether the fact that funds might be exhausted during an annuitant’s lifetime makes the transaction more like a transfer in trust with a retained interest than like an annuity.

Unlike an annuity, a trust does not guarantee that a beneficiary will continue to receive income, as once the trust’s assets are exhausted, the income ends. Like the annuitant, the beneficiary can calculate a stream of payments based on his life expectancy; however, unlike the annuitant, if he lives longer than this, he cannot expect the income to continue. A key factor in differentiating between a transfer in trust and an annuity thus seems to be the iden-

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Bixby, 58 T.C. 757, and Samuel, 306 F.2d 682.
103. See Rev. Rul. 77-454, 1977-2 C.B. 351, where the IRS takes the position that the present value of an annuity must be reduced due to the chance that the limited fund from which it is payable might be exhausted before the annuitant’s death.
104. Here, the courts do not appear to be using the term “continuing interest” in a control sense, but rather in the sense that the annuitant has a vested interest in the adequacy of the trust properties.
tity of the party assuming the risk that life expectancy will be exceeded. If a person makes a transfer in trust reserving a fixed annual payment for life which is calculated to exhaust the fund if he lives out his life expectancy, then the transferror bears this risk as he will not receive an income after a certain time. In the normal annuity situation on the other hand, the payor of the annuity assumes the longevity risk because he has guaranteed that he will make payments even past this time. If the payor is a trust with no other assets, however, the promise to pay for the annuitant's lifetime is somewhat illusory since there are no other assets backing this promise. That is, there is no other source of the guaranteed income once the trust's assets are depleted.

Whether this assumption of risk should be sufficient to produce a recharacterization is not immediately obvious since there are other situations in the private annuity context which could produce the same result. In addition, the mere non-private nature of a regular annuity arrangement does not guarantee in itself the solvency of the payor even though that nature makes solvency more likely. Regardless of whether this assumption of risk factor is conclusive, neutralizing that factor by structuring the transaction in such a way as to arguably eliminate this problem would be worth the effort.

Several cases have criticized annuity-sale transactions on the ground that they were not at arm's-length. Courts have used this argument to buttress the conclusion that the transaction was more properly treated as a transfer in trust. The simultaneous creation of the trust and the sale for an annuity have been used as evidence of the non-arm's-length nature of the transaction. Courts have treated attempts to give the two steps independent significance in summary fashion and have not hesitated to find them to be interrelated steps in a single plan. While the elimination of a

105. A transfer to a payor or existing trust which has substantial assets in addition to those transferred in return for the annuity promise is no guarantee of future performance. Investment reverses could always produce a fund which was inadequate at some point. How much additional assets are needed and their method of acquisition by the trust would present additional problems.

106. This could be done by having the trust beneficiaries, or others, personally guarantee payment of the annuity. It could also be accomplished by using an existing trust which has already been adequately funded in a transaction totally separate from the private annuity. However, the possibility always looms that this existing trust may not have adequate resources. See supra note 105.

107. Apparently these cases have reasoned that "sales" are usually at arm's-length while "transfers in trust" usually are not since they normally involve a gift element. However, the absence of a gift element in a transaction with a trust could, using the same criteria, indicate a sale. This is because without a gift element it would be unlike a normal transfer in trust.

108. Discussing the annuity and the trust agreement, the Ninth Circuit quoted the
separate trust-creation enabled the IRS to make the non-arm’s-length argument, that argument does not simultaneously raise and conclude the issue. The interrelationship of these steps merely creates a possibility, but does not invariably lead to the conclusion, that there was a transfer in trust rather than a sale. In this respect, the non-arm’s-length argument is not determinative.

Another way in which the transaction may not be at arm’s-length is in the determination of the sales price of the property and the annuity amount. The present value of the annuity payments should equal the fair market value of the property being transferred. The fair market value of the property should be determined using appropriate valuation techniques and, once arrived at, IRS-mandated procedures should be used to determine the annuity amount. While IRS procedures prevent the determination of a truly arm’s-length annuity amount, the Tax Court’s criticism here has been focused on situations where no interest element was included in the annuity. The presence of a gift element arguably is more characteristic of a transfer in trust than a sale for an annuity. Therefore, any situation where either the property is undervalued or the annuity is miscomputed produces a gift element and leaves the door open for a non-sale characterization.

Following the proper form in an annuity transaction is extremely important, including proper documentation, timely transfer of assets to the buyer, insistence on timely annuity payments in the correct amounts, and otherwise dealing with the trust as one would a completely unrelated payor.

Tax Court, as follows: “No one of them would have been signed without the other; each was dependent upon the other.” The court held, therefore, that all of the instruments must be considered together in determining whether or not a valid annuity agreement was made.” Lazarus v. Comm’r., 513 F.2d 824, 829 (9th Cir. 1974).

109. See supra note 6 and accompanying text.
110. See supra note 92 and accompanying text.
111. In LaFargue, 73 T.C. 40, and Benson, the fair market value of the property transferred was equal to the total annuity payments to be made, not their present value.
112. Failure to follow the form of a private annuity makes the government’s substance versus form argument even stronger.

113. Several of the annuity cases cite irregularities in administering the annuities as factors which may tend to mitigate against annuity treatment. See Estate of Fabric v. Comm’r., 83 T.C. 940 (1984), Benson v. Comm’r., 80 T.C. 789 (1983), and LaFargue, 73 T.C. 40. However, only in Lazarus, 58 T.C. 854, and Horstmier v. Comm’r., 46 T.C.M. (CCH) 738 (1983) did this ultimately lead to a result invalidating the annuity.

114. The Ninth Circuit in LaFargue emphasized the importance of adhering to the proper formalities as follows:

We are convinced that the annuity characterization comports with the formal structure of the transaction and accurately reflects its substance. . . . [T]he fundamental annuity obligation has not been ignored or modified. Under these circumstances, . . . we cannot justify disregarding the formal structure of the transaction as a sale in exchange for an annuity.
III. The Determining Characteristics

It should be apparent from the courts' struggles in distinguishing a sale to a trust in exchange for an annuity from a transfer in trust with a retained life interest that these two forms of investment are extremely similar. In an annuity transaction, the seller of the annuity receives the purchase price, invests the funds, and pays the principal and expected income back to the purchaser, less an amount for administrative expenses, mortality reserves, and profit. In a sense, then, every annuity is a transfer of property with a retained income interest since the annuitant is treated as receiving income from the payor. However, the IRS does not take this position, since that would be straining to tax arm's-length arrangements. But, this merely points out the difficulty in solving the problem: The two interests are very much alike. Therefore, even ignoring the form, the substance is similar.

The initial question posed in this Article still remains: What is the essential difference between an annuity and a retained income interest? The distinction appears to be in the nature of the interest received by the transferee of the property. In a transfer in trust with a retained interest, there is usually a substantial gift element, together with a clear intent to pass such gift to the remaindermen. In contrast, an annuity is intended to exhaust both the property transferred and the income therefrom leaving nothing for the payor except the profit on the transaction. If this is the essential difference, why would a trustee, person, or entity enter into a private annuity transaction from which he expects to receive little or nothing? The answer appears to be that if dealing at arm's-length, the payor would indeed have something left: a profit on the transaction. This profit would be large enough to compensate for the mortality risk.

Another difference which is certainly relevant relates to the amount of the payments. Annuity payments normally would be

689 F.2d at 846-47.
115. See I.R.C. § 72 and supra notes 5 and 30 and accompanying text.
116. The payment of premiums to the insurance company could also be viewed as valid consideration, negating the gift element required under I.R.C. § 2036.
117. While a gift in trust with a retained income interest is certainly capable of being structured to allow the transferror the right to consume a major portion, if not all, of the corpus, in developing criteria for differentiation purposes, it seems more appropriate to compare a "normal" annuity with a "normal" retained interest, and leave the difficult or hybrid cases to subsequent analysis and consideration of other, normally marginal, factors.
118. This analysis essentially reverses the impact of the "source of payment" factor discussed supra text accompanying notes 104-05.
119. As pointed out supra note 89 and accompanying text, the IRS has made the arm's-length structuring of a private annuity impossible. Therefore, any arguments addressed to lack of arm's-length dealings in this area should be irrelevant.
fixed, while income interest varies with the trust’s income. While a retained interest could certainly be structured in a fixed manner, and variable annuities do exist, it seems reasonable to find that fixed payments receive annuity treatment and that payments which vary with the income, liquidity, or solvency of the trust indicate a retained interest.

If the major factors in an analysis are the absence of a gift element and the fixed nature of the payments, what other consequences should a taxpayer be aware of in establishing his investment to receive the desired tax benefits of an annuity? Clearly, retained, actual control, as in Samuel and Bixby, is inconsistent with a “sale” of the property and annuity treatment. Structuring the transaction to fix the payments at the amount of income produced, as in Lazarus, should also be fatal to annuity treatment. The presence of a gift element, such as in LaFargue,¹²⁰ should also be some indication of a retained interest.¹²¹ Slight deviation in the form of a delayed transfer of some assets or failure to insist on timely payments or similar items should not be accorded much weight except in very close factual situations. These deviations, as long as they have no real or permanent effect on the underlying obligations, should not change the nature of the transaction.

If all else fails, perhaps the taxpayer’s final argument should be that if substance is similar enough, form should govern. The form versus substance argument always has been made and accepted in situations where the economic substance was substantially different from the form in which it was cloaked. Such is not the case here. In cases where substance is similar, a taxpayer ought to have freedom of choice between establishing an annuity or a trust as long as the proper form is followed and what was actually done follows the form.

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¹²⁰ In that case, the annuity payments equalling the income produced was due to an improperly computed annuity amount.

¹²¹ This should not apply if the “gift” element can be separated or the gift itself shown to have been a mistake.