Lazarus v. Commissioner, 58 T. C. 854 (1972)

A transfer of property to a trust, structured to appear as a sale in exchange for an annuity, may be treated as a transfer with a reservation of income if the economic substance indicates income distribution rather than a sale.

Summary

In Lazarus v. Commissioner, the petitioners transferred stock in a shopping center to a foreign trust, which then sold the stock to a third party. The trust was to pay the petitioners $75,000 annually, purportedly as an annuity. The U. S. Tax Court held that this was not a sale but a transfer with a reservation of income, taxable under sections 671 and 677 of the Internal Revenue Code. The court focused on the economic reality that the payments to the petitioners mirrored the trust's income, indicating a reservation of trust income rather than a sale for an annuity. This ruling has significant implications for structuring estate and tax planning to avoid unintended tax consequences.

Facts

In 1963, Simon and Mina Lazarus transferred stock in a corporation owning a shopping center to a foreign trust they established, purportedly in exchange for a private annuity of $75,000 per year. The trust then sold the stock to World Entertainers Ltd. , receiving a promissory note with annual interest payments of $75,000. The trust's only assets were the note and $1,000 in cash. The Lazarus couple received payments from the trust, which they treated as non-taxable recovery of their investment in the stock.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Lazarus couple's income and gift taxes, asserting that the transaction was a transfer to the trust with a reservation of income rather than a sale. The case was heard by the U. S. Tax Court, which issued its decision on August 17, 1972.

Issue(s)

1. Whether the transfer of corporate stock to the trust was a sale in consideration for annuity payments, or a transfer to the trust subject to a retained right to the income.
2. Whether the petitioners made a gift to the trust of a portion of the value of the stock.
3. Whether certain lease deposits, retained by Simon M. Lazarus upon the formation of & V Realty Corp. , represent income to petitioners in 1963.
4. Whether interest paid by petitioners on mortgages on the shopping center during 1964 and 1965 is properly deductible.

Holding

1. No, because the transaction was structured to transfer the stock to the trust with the petitioners retaining the right to the trust's income, falling within section 677 of the Internal Revenue Code.
2. Yes, because the transfer to the trust constituted a gift of the remainder interest in the stock.
3. No, because the lease deposits were not income to the petitioners in 1963 as they were not transferred to & V Realty Corp. and were later returned to Branjon, Inc.
4. Yes, because the transaction was a transfer in trust rather than the purchase of an annuity, making the interest deductions allowable under section 264(a)(2) of the Internal Revenue Code.

Court's Reasoning

The court examined the substance of the transaction, finding that the annual payments to the petitioners were essentially the trust's income from the promissory note. The court noted that the trust's corpus remained intact for the benefit of the remaindermen, indicating a transfer in trust with income reserved rather than a sale. Key policy considerations included preventing manipulation of tax laws through trust arrangements. The court referenced cases like Samuel v. Commissioner and Estate of A. E. Staley, Sr. to support its conclusion that the transaction's form as a sale did not align with its economic substance. The court emphasized that the absence of a down payment, interest on deferred purchase price, or security in the alleged sale suggested the transaction's true nature as a trust with income reserved.

Practical Implications

This decision underscores the importance of aligning the form and substance of estate and tax planning transactions. Attorneys must carefully structure trust arrangements to ensure they do not inadvertently trigger income tax under sections 671 and 677. The ruling impacts how similar cases should be analyzed, emphasizing the need to look beyond formal labels to the economic reality of transactions. It also affects legal practice in estate planning, requiring practitioners to consider the tax implications of trusts designed to resemble sales. For businesses and individuals, this case highlights potential pitfalls in using trusts for tax avoidance. Later cases like Rev. Rul. 68-183 have applied similar reasoning to transactions structured as private annuities but treated as income reservations.

