La Fargue v. Commissioner, 73 T. C. 40 (1979)

A transfer of property to a trust in exchange for an annuity may be treated as a grantor trust if the substance of the transaction indicates the grantor retained an interest in the trust.

Summary

Esther La Fargue transferred assets to a trust she created and received annual payments in return, claiming the transaction was a sale for an annuity. However, the Tax Court held that the substance of the transaction was a transfer in trust with a reserved interest, not a sale for an annuity, and thus the payments were taxable to La Fargue under the grantor trust rules. The court considered the totality of circumstances, including the absence of an interest factor in the annuity calculation and the direct relationship between the transferred assets and the payments, to conclude that La Fargue retained a beneficial interest in the trust.

Facts

Esther La Fargue inherited a substantial estate and sought to manage her assets. She established a trust with a nominal corpus of $100, appointing her sister, a friend's son, and her attorney as trustees. Two days later, she transferred assets worth $335,000 to the trust in exchange for annual payments of $16,502 for life. The payment amount was calculated by dividing the asset value by La Fargue's life expectancy of 20. 3 years, with no interest factor included. The trust was intended to benefit her daughter and other relatives, but the operation of the trust was informal, and La Fargue continued to receive dividends from the transferred stocks directly.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in La Fargue's income tax for 1971, 1972, and 1973, asserting that the payments received from the trust were taxable income. La Fargue petitioned the U. S. Tax Court, which held that the transaction constituted a transfer in trust with a reserved interest, not a sale for an annuity, and thus the payments were includable in her income under the grantor trust provisions.

Issue(s)

1. Whether the transaction between La Fargue and the trust should be treated as a sale or exchange for an annuity or as a transfer in trust with a reserved interest?

2. If treated as a transfer in trust, to what extent is La Fargue taxable on the income of the trust under the grantor trust provisions?

Holding

© 2025 SCOTUSreports.com. All rights reserved.

1. No, because the substance of the transaction indicated a transfer in trust with a reserved interest rather than a sale for an annuity, as evidenced by the totality of circumstances including the lack of an interest factor and the direct relationship between the transferred assets and the payments.

2. La Fargue is taxable on the trust's income up to the amount of the annual payment of $16,502, as the trust's income was contemplated to be used for these payments, and any excess income was required to be distributed to other beneficiaries.

Court's Reasoning

The Tax Court applied the principle that the substance of a transaction governs its tax consequences, not its form. It analyzed several factors to determine that the transaction was not a bona fide sale for an annuity but a transfer in trust with a reserved interest:

– The trust and annuity were part of a prearranged plan, and the trust would have been an empty shell without the transferred assets.

– The transferred property was the source of the payments to La Fargue, indicating a retained interest.

– The absence of an interest factor in the annuity calculation was uncharacteristic of an arm's-length transaction.

– The administration of the trust and annuity suggested La Fargue viewed herself as the beneficial owner of the property.

– The court rejected La Fargue's reliance on the absence of a direct tie-in between the trust income and the annual payment, stating that the totality of circumstances was determinative.

The court also held that under the grantor trust provisions, La Fargue was taxable on the trust's income up to the amount of the annual payment, as the trust's income was intended to fund these payments.

Practical Implications

This decision emphasizes the importance of substance over form in determining the tax treatment of transactions involving trusts and annuities. Practitioners should carefully structure such transactions to avoid unintended tax consequences, ensuring that the substance of the arrangement aligns with the desired tax treatment. The ruling also highlights the need to consider the totality of circumstances, including the relationship between transferred assets and payments, the presence or absence of an interest factor, and the administration of the trust, when analyzing similar cases. Subsequent cases have continued to apply the

© 2025 SCOTUSreports.com. All rights reserved.

substance-over-form doctrine in the context of trust and annuity arrangements.

© 2025 SCOTUSreports.com. All rights reserved.