Sidney B. and Vera L. Stern v. Commissioner of Internal Revenue, 77 T. C. 614 (1981)

Transfers to a trust in exchange for purported annuities will be treated as transfers subject to retained annual payments if the annuitant retains control over trust assets or benefits.

Summary

The Sterns transferred Teledyne stock to two foreign trusts in exchange for lifetime annuities, aiming to defer capital gains and minimize estate taxes. The Tax Court ruled that these transactions were not sales for annuities but transfers in trust, with the Sterns as settlors, subject to retained annual payments. This decision was based on the Sterns' significant control over the trusts, their status as beneficiaries, and the trusts' dependency on the transferred stock for annuity payments. Consequently, the Sterns were taxed on the trusts' income, including capital gains from the stock's sale, under the grantor trust rules.

Facts

In 1971, Sidney Stern, following advice from his attorney, transferred substantial Teledyne stock to the Hylton Trust, which he and his family were beneficiaries of, in exchange for lifetime annuities. In 1972, he transferred more Teledyne stock to the Florcken Trust, with his wife Vera as a beneficiary, for a similar arrangement. Both trusts were nominally established by others but controlled by the Sterns, who influenced investment decisions and trust administration.

Procedural History

The Commissioner issued a deficiency notice, asserting the transactions were either closed sales or transfers in trust. The Tax Court consolidated related cases and ruled in favor of the Commissioner, treating the transfers as trust arrangements subject to retained payments.

Issue(s)

1. Whether the transfers of Teledyne stock to the Hylton and Florcken Trusts in exchange for annuities should be treated as sales or as transfers in trust subject to retained annual payments.
2. Whether the Sterns are the real settlors of the Hylton and Florcken Trusts.
3. Whether the Sterns should be taxed on the trusts' income under the grantor trust provisions.

Holding

1. No, because the transactions constituted transfers in trust with retained annual payments, not sales. The court found that the Sterns' control over the trusts and the

trusts’ dependency on the transferred stock for annuity payments indicated a trust arrangement.
2. Yes, because the Sterns were the true settlors. The nominal settlors contributed only minimal amounts compared to the Sterns’ substantial stock transfers, and the trusts were orchestrated by the Sterns for their estate planning.
3. Yes, because the Sterns are taxable on the trusts’ income under section 677(a) due to their status as beneficiaries and the trusts’ income being held or accumulated for their future distribution.

Court’s Reasoning

The court emphasized the substance over form doctrine, noting the Sterns’ control over trust assets, their status as beneficiaries, and the trusts’ reliance on transferred stock for annuity payments. Key considerations included the trusts’ creation as part of a prearranged plan with the Sterns, the nominal settlors’ minimal contributions, and the Sterns’ influence over trust investments and administration. The court cited precedent where similar arrangements were treated as trusts, not sales, due to the annuitant’s control and the nexus between transferred assets and annuity payments. The court rejected the Sterns’ argument of an arm’s-length transaction, finding their control over the trusts akin to beneficial ownership.

Practical Implications

This decision impacts how similar transactions should be analyzed, emphasizing the need to scrutinize arrangements involving trusts and annuities for their substance. It clarifies that control over trust assets and the source of annuity payments are critical factors in determining whether a transaction is a sale or a transfer in trust. Practitioners must carefully structure such arrangements to avoid unintended tax consequences under grantor trust rules. The ruling may deter taxpayers from using similar strategies to defer capital gains or reduce estate taxes, as it reinforces the IRS’s ability to challenge transactions based on their economic reality. Subsequent cases have referenced this decision when addressing the tax treatment of transfers to trusts in exchange for annuities.

